

Managing Credit

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What Is Credit?

Credit is an agreement a consumer makes to receive cash, goods or services now and pay later. Credit often adds fees and interest to the total cost. Consumers must be aware of their rights and responsibilities when using credit. This fact sheet explains the basics of managing credit.



Why Use Credit?

Many consumers find it convenient to use credit. Renting a car, making hotel or plane reservations and shopping online are difficult without a credit card. Using credit is necessary to develop a credit history. Your credit score is based on a record of your credit management history. A good credit score can help you to qualify for the best rates and terms for credit cards, car loans and home mortgages. Credit can be important in case of an emergency. Credit makes it possible to use an item, like an appliance or a car, while you are paying for it. Credit allows you to take advantage of special bargains and sales. Buying on credit may make it easier to return items or get a refund.

Disadvantages of Using Credit

Using credit costs money. Paying interest on purchases can add up quickly. Fees and penalties add even more to the cost. Credit can tempt you to overbuy or buy on impulse. Purchasing items on credit can tie up future income. Overspending with credit can lead to financial stress or even bankruptcy.

Types of Credit

Many consumers use credit to purchase homes, cars or a college education. These loans from banks or credit unions are *installment credit*. The loan is given for a set amount of time and interest. The consumer repays the debt in regularly scheduled payments.

Another type of credit is the *charge account*. Businesses that provide charge accounts require the credit to be paid in full each month.

Revolving credit is another type. Consumers use revolving credit with credit cards from businesses such as banks, stores or gas stations. The consumer can continue to add to the charges as long as they do not exceed the account's credit limit. Minimum payments are required at regular intervals. Interest is charged on the remaining balance during each payment period.

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Cost of Credit

The cost of credit will depend on the type of credit, the lender or creditor, the ways a consumer uses credit and economic conditions. The interest rate, finance calculation method and fees affect the total cost.

Interest Rate

- **Annual Percentage Rate (APR)** – The higher the interest rate, the more you pay. So, look for the lowest APR available when shopping for credit. The annual percentage rate is the amount you will pay for credit during a year. Be sure to look at the ongoing APR and not just the introductory APR. Some companies increase rates if payments are late. For new accounts, regular rates cannot be increased for at least 12 months unless your payment is more than 60 days late. The credit card company must notify you at least 45 days in advance of any increases to your interest rate or fees. When rates do increase, they can only be applied to new purchases.
- **Variable Interest Rate** – If you have a card with a variable interest rate, your rates will increase when the index increases. An index is an economic indicator used to calculate interest-rate adjustments. For example, a credit card company may charge the amount of the index plus 11.65 percent. The fees disclosures will list which index the company uses. The company doesn't have to notify you every time there is a rate change due to a change in the index.
- **Introductory APR** – An introductory APR is a special, lower rate that applies for a fixed period (usually a few months) at the beginning of card ownership. After this period the APR increases. Introductory rates must last for at least six months. The credit card company doesn't have to notify you about the change from introductory to regular rates.

Finance Calculation Method

- **Average Daily Balance** – The finance charge is figured by adding the outstanding balance for each day in the billing cycle. The total is then divided by the number of days in the cycle. This is the most commonly used method of computing finance charges. A good credit score will help you to qualify for a lower APR. New purchases are usually included. The credit card offer will state if the finance calculation method includes or does not include new purchases.

Fees

- **Annual** – Some credit cards do not have an annual fee. The better your credit score, the more likely you are to qualify for a card with no or low annual fees.
- **Late** – Most credit card companies charge fees for payments not received by the due date or closing date specified on the monthly statement. This fee will occur each month the payment is late.



- **Over-the-Limit** – Credit agreements state the highest amount the consumer is allowed to charge. A fee may be charged for amounts over the credit limit. Over-the-limit fees can't be charged unless you choose to allow over-the-limit purchases. Otherwise, if you're at your credit limit, the purchase won't be permitted. If you do choose to allow over-the-limit purchases, the company can charge you only one over-the-limit fee per billing cycle
- **Finance** – The finance charge is the total dollar amount a consumer pays to use credit. Some credit card issuers charge a minimum finance charge even if the account is paid in full each month.
- **Balance Transfer** – Balances may be transferred from one account to another for a fee.
- **Cash Advance** – Be aware that a higher APR will likely apply to cash advances. The higher cash advance APR usually applies to the "credit card checks" you receive in the mail.

How Much Credit Can I Afford?

There is no single, simple answer to this question. Consider this guideline: Have no more than 20 percent of take-home pay committed to consumer credit. This does not include the amount owed on a home mortgage. Other experts advise not owing more than 10 to 15 percent of take-home pay in credit debt, and this amount should be repayable within 24 months.

How much credit a family can afford depends on family size, job stability, income and current credit obligations. Consumers should also consider how any added credit payments will fit into overall spending and still leave funds for emergencies.

Consumers should set a personal credit limit and stay within that amount. The amount available to a consumer may be more than he or she can afford, especially if they have several accounts. Always know the total amounts you owe and stick to that personal limit. If any of the signs below apply, you may need help.

Credit Danger Signs

Many problems can be avoided if you carefully read all the information that companies or businesses include on a credit card offer, statement or any other type of credit contract. If the information is unclear, ask questions BEFORE signing anything. If any of the statements below apply to your financial situation, you may have a credit problem.

- Paying only the minimum amount due each month.
- Borrowing money to pay fixed expenses such as rent or car payments.
- Opening additional accounts to increase the amount you can borrow.
- Using credit card advances to pay for everyday living expenses.
- Charging more each month than you are paying.
- Using savings each month to pay credit debt.
- Having little or no savings.

Ways to Reduce Credit Costs

There are ways you can reduce the cost of using credit. Some methods include:

- Borrow or charge the least amount possible. This may involve saving for an item for several months before making a purchase.
- Shop around for the best credit payment options.
- Make the highest monthly payments you can afford.
- Keep the number of credit cards you have at a minimum.
- Pay off credit card debts with the highest interest rates as quickly as possible.
- Use credit only when needed. Before buying anything, ask yourself: Do I need this?

Can I afford it? Would it be better to save and purchase it with cash?

- Keep good records.
- Always know the total amount you owe.
- Report any errors on statements at once.

Credit Problems

If you recognize credit problems, begin working on them NOW. Make no new charges. You may need to cancel accounts. Contact creditors if you see that payments may be late or missed. Do not wait for them to contact you. Before you contact them, know what you owe. Be honest. Be willing to work out a payment plan and stick to it. Try to find ways to increase your income and/or decrease your expenses. Apply extra money to pay off debt.

Help Is Available

- Your local County Extension Office can provide information and education programs on credit, money management, consumer protection, saving and consumer skills. To find your County Extension Office, visit our website at www.uaex.edu.
- PowerPay is an Extension program that features an online financial calculator to help you design your fastest debt repayment plan. Visit <https://powerpay.org> to explore a variety of options and design your best repayment plan.
- Credit counseling services help individuals and families that are in financial trouble. Many are nonprofit and charges are nominal.
- Debt consolidation is one large loan used to pay off various outstanding debts. It stretches out payments over a longer period of time, and you pay more interest. The single payment is smaller than the total of the other payments, and it is easier to keep track of one debt. Be careful when considering consolidation loans. You may be tempted to add new credit obligations since your existing payment seems so “small.”
- Bankruptcy is a final option. It is not a step to be taken lightly, but it may be the only option in certain situations.

Remember

Credit should be used for things that last long after the final payments have been made. Be informed. Choose your credit cards wisely. Consider credit purchases carefully. Protect your financial security and build wealth.

References

All About Credit Reports

Annualcreditreport.com

<https://www.annualcreditreport.com/whatIsCreditReport.action>

Bankruptcy Information Sheet

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http://www.usdoj.gov/ust/eo/ust_org/bky-info/index.htm

Building a Better Credit Report

Federal Trade Commission

<https://www.consumer.ftc.gov/articles/pdf-0032-building-a-better-credit-report.pdf>

Credit Repair: How to Help Yourself

Federal Trade Commission

<https://www.consumer.ftc.gov/articles/0058-credit-repair-how-help-yourself>

Using a Credit Card

Federal Trade Commission

<https://www.consumer.ftc.gov/articles/0205-using-credit-card>

Credit Cards

Consumer Financial Protection Bureau

<https://www.consumerfinance.gov/ask-cfpb/category-credit-cards>

Your Credit Scores

myFICO Credit Education Center

<https://www.myfico.com/credit-education/credit-scores>

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