

Topic 2: Dealing With Debt

- The many types of debt in your life
 - Student loans, credit cards, car loans, mortgages, etc.
 - Widely varying costs and features
- Credit reports & credit scores
 - How they impact you
 - How your actions affect them
- Limits to your borrowing capacity (TBD)
- Credit problems & credit fraud (TBD)

Credit Cards – Key Features

- When you use a credit card the bank is lending you the money to make the purchase
- Great way to make purchases if you intend to pay balance in full
 - No interest is charged if you pay balance in full during grace period
 - Excellent fraud protection on US cards (TBD)
 - Can help your credit score if used judiciously (TBD)
- But a terrible way to borrow money
 - Very high Interest rates on average monthly balance if you don't pay off these balances in full each month

Average Interest Rates – Credit Cards (5/29/2023)

Type/Transaction	APR	Effective Rate
Credit Card		
New Offers	22.29%	24.7%
Store Card	29.83%	34.3%

**Notes: These interest rates are typically “float” with interest rates (often the “prime rate,” and will increase if market rates go up.*

Banks are required to disclose all costs to you – read this document

Source: Wallet Hub Website (average APRs)

Average Interest Rates – Credit Cards (5/29/2023)

Type/Transaction	APR	Effective Rate
Credit Card		
Purchases – New Offers	22.29%	24.7%
Cash Advance	24.22%*	27.1%
Penalty (Late, < Min Payment)	26.86%**	30.4%
Store Card	29.83%	34.3%

Notes:

- * *Cash advances are often charged an up-front fee of 3-5% and there is no grace period for interest charges on cash advances.*
- ** *Expect to be assessed a late payment fee as well, and max rate can be applied for a long time.*

Source: Wallet Hub Website (average APRs)

Average Interest Rates – Credit Cards (5/29/2023)

Type	APR	Effective Rate
Credit Card		
New Offers	22.29%	24.7%
Excellent Credit Score	17.40%	18.9%
Good Credit Score	23.35%	26.0%
Fair Credit Score	25.58%	28.8%

Note: Actual APRs varied from 11½ % to over 30%!

Source: Wallet Hub Website (average APRs)

Don't Just Make The Minimum Payment

- Generally just a little bit higher than your interest charge
- Will likely take you 10—20 years to pay off your credit card debt if you only make the minimum payment
 - You can check out the implications of your card by typing in your card's APR and minimum payment terms into the BankRate Minimum Payment Calculator.
- Question: How else can you make a risk-free return of 20%+ on your savings?

How Long Will It Take to Pay Off Your Card?

Paying Off A \$1,000 Balance (Assuming an APR of 19% and Min Payment of 2%)			
Monthly Payment	Time to Pay off Debt	Total Payments	Total Interest
Min Payment	169 months	\$2,698	\$1,698
Fixed \$20	100 months	\$1,997	\$997
Fixed \$30	48 months	\$1,433	\$433
Fixed \$40	33 months	\$1,283	\$283
Fixed \$50	25 months	\$1,212	\$212

Calculations performed using the BankRate Minimum Payment calculator

How Long Will It Take to Pay Off Your Card?

Paying Off A \$2,000 Balance (Assuming an APR of 19% and Min Payment of 2%)			
Monthly Payment	Time to Pay off Debt	Total Payments	Total Interest
Min Payment	336 months	\$7,497	\$5,497
Fixed \$40	100 months	\$3,994	\$1,994
Fixed \$60	48 months	\$2,865	\$865
Fixed \$80	33 months	\$2,566	\$566
Fixed \$100	25 months	\$2,424	\$424

Calculations performed using the BankRate Minimum Payment calculator

Reminder: Importance of Compounding

Growth of \$1,000 40 Years From Now

APR	Monthly Compounding*
2%	\$2,224
4%	\$4,940
6%	\$10,957
8%	\$24,273
10%	\$53,701
⋮	⋮
20%	\$2,790,748
30%	\$140,428,542

Paying off your credit cards ASAP is an amazingly good investment.

- *No risk*
- *No taxes*
- *But incredibly high returns*

* $APR \equiv \text{Annual Percentage Rate}$; Monthly interest rate = $APR/12$

Strategies to Reduce Credit Card Interest

Case 1: You have extra cash

- Use it to reduce credit card balances on either
 - The highest rate cards or
 - Cards where you have low balances and can quickly pay off the debt.
 - Idea is to restore grace period treatment on that card.
 - Just make sure you know the rules for restoring grace period treatment – they vary with cards.

Strategies to Reduce Credit Card Interest - 2

Case 2: You have a high credit score (FICO = 670+)

- Ask for a cheaper rate on your current cards
- Look to transfer balances to a cheaper card
 - Can find many offers at BankRate and other websites with lower rates
 - These offers often include teaser rates (typically an initial APR of 0% which is usually good for 12-21 months)
 - Key
 - Make payments during the teaser period (*when 100% of your payment is being used to reduce your debt*).
 - Be sure to read the fine print regarding fees, and interest rates on balance transfers after teaser period
 - Note you do **NOT** want to become a "serial balance transferor."
(*I will cover the reasons for this later.*)

Paying Off Your Card – Impact of Interest Rates

Paying Off a \$1,000 Balance With a \$30 Monthly Payment			
Card APR	Debt Paid Off in	Total Payments	Total Interest
26%	60 months	\$1,793	\$793
23%	54 months	\$1,610	\$610
17%	46 months	\$1,362	\$362

Paying Off Your Card With Balance Transfers

Paying Off a \$1,000 Balance With a \$30 Monthly Payment			
Card APR	Debt Paid Off in	Total Payments	Total Interest
26%	60 months	\$1,793	\$793
23%	54 months	\$1,610	\$610
17%	46 months	\$1,362	\$362
Promotion*	34 months	\$1,040	\$40

* Assumed promotion is an APR of 0% for 21 months followed by 17% thereafter.

Calculations performed using BankRate Credit Card Payment Calculator

Strategies to Reduce Credit Card Interest -3

Case 3: You don't have a high credit rating

- Probably won't be getting balance transfer promotions.
- So strategy is:
 - Work on paying off existing debt (*by increasing monthly payments*)
 - See if you can get a card with grace period treatment
 - Use it for normal purchases
 - And pay off balances on that card in full each month
 - Start doing things that will increase your credit score (TBD)
 - And then take advantage of your improved score to lower credit costs

Credit Card: Other Costs & Benefits

- Annual Fee – look for zero fee cards.
- Foreign exchange (FX) fees:
 - Credit cards can be either one of the cheapest or one the most expensive ways to make purchases abroad – depending on the card
 - Does the card have a per transaction fee?
 - Understand bid/ask spreads
- Rental car insurance
 - Some – *but not all* - credit cards provide free rental car insurance if you use their card when charging a rental car.
 - Need to use that card when making the reservation, at the counter, and charging car rental when turning car in.
 - Make sure you read card terms before assuming you are getting this feature.

Key Take-Aways

- Comparison shop for cards (& *read the fine print*)
- Pay off monthly balances in full if you can
 - You can do this by setting up automatic payments (TBD)
- Pay off outstanding balances ASAP
- Avoid cash advances, skip payment programs, CC checks, etc.
- Check fees and benefits (annual fee, FX costs, rental car insurance)
- Be sure to check monthly statements for errors
 - Can dispute them
 - And you will help protect yourself from identity theft
- Be sure to think about how you can use credit cards to **IMPROVE** your credit score (TDB)

Topic 2: Managing Your Credit Profile

- Suppose you apply for a loan.
- Who determines the cost and availability of this credit?
 - The bank
 - The credit bureau
 - And you
- Two questions
 - What is a credit bureau and what do they do?
 - How do your actions impact assessments of your credit worthiness?

Credit Bureaus/Credit Records/Credit Scores

- Three major credit bureaus in the US
 - Equifax
 - Experian
 - TransUnion
- These firms:
 - Collect information on your credit & payment history (*credit record*)
 - Compute a summary measure of your credit worthiness (*credit score*)
 - And they sell this information to others

Note: The first company to compute credit scores was Fair Issacs Corporation in 1989, which is why your credit score is often called a FICO score.

What's On Your Credit Record?

- Detailed personal information, including
 - Name(s)
 - Current and past addresses
 - Social security number
- Detailed information on your credit history
 - All loans (*including credit cards, stuff bought “on time,” and some past debts*)
 - For each “loan”
 - Amount and date credit was extended
 - Credit limit, payment history, all levels of delinquency if any missed payment has occurred, and current amount outstanding
 - For example late payments are often grouped in buckets (30 days late, 60 days late, 90 days late)
 - Loan could also be classified as being “charged off”, sent for collection, etc.)
- Public records such as bankruptcies, judgments or tax liens
- All entities that have recently asked to see your credit report

Protecting Yourself

1. Check your credit report for mistakes

- About 1 in 3 reports have an error (often but not always minor)
- Credit bureaus must provide you with a free report
 - Once a year
 - If a company has taken adverse action against you in the last 60 days (e.g. denial of credit, insurance, employment, foreclosure, etc.),
 - If you are on welfare or are unemployed and intend to look for a job in the next 60 days, or
 - You are a victim of identity theft (TBD).
 - ***But only if you ask for the report!***

Protecting Yourself - 2

1. *(continued)*

- No need to pay a service for these reports
 - Waste of money, risk of identity theft (*if a scammer*)
 - Just contact the credit bureaus online for the free report
 - Consider staggering the bureaus to get a free report more often.
 - Differences among reports tends to be very small.
 - What if you want to see your report more often than that?
 - Kobliner says you can sign up for free credit report information at web sites like CreditKarma.com

2. What if you find a mistake?

- Contact credit bureau and dispute it.
- Credit bureau only has 30 days to verify information
- And are otherwise legally required to delete it

Negative Information & Your Credit Record

Bad News: Most stuff can stay on your record for 7 years.

Good News: Credit bureaus give much more weight on the last 2 years when calculating your credit score.

However: Adverse credit events (*e.g. bankruptcy, foreclosure, loan charge-offs*) will remain a focus for a long time.

Indeed, you should expect a bankruptcy to have a sizable, negative impact on your credit score for 10 years.

What About Your Credit Score?

- Summary measure of your credit worthiness
 - Often called your “FICO” score
 - *Since first calculated by Fair Issacs Corp. in 1989*
 - Calculated by credit bureaus and sold separately from your credit report.
- Why does it matter?
 - About 90% of lenders in the US rely on your FICO score to determine
 - Whether or not to offer you credit
 - And the terms of that credit (down payment, interest rate, etc.)
 - Landlords often check your credit score before deciding whether or not to rent you an apartment.
 - Auto insurers use your credit score to set insurance rates
 - Potential employers:
 - Do not have access to your credit score
 - But they can look at your credit record before deciding whether or not to offer you a job.

Understanding Your Credit Score

- FICO scores
 - Range from: 300 - 850
 - Average score: 700
 - Ratings:
 - Exceptional: 800+
 - Super-Prime: typically 720+ (sometimes 750+)
 - Prime: typically 670+ (sometimes 700+)
 - Then come various levels of subprime
- Other credit bureaus can assign a different score and have different ranges.
 - Equifax: 280 - 850
 - Experian: 330 - 830
 - TransUnion: 150 - 950

Key Credit Score Determinants

- Credit bureaus don't know your income or net worth
 - So can't judge if current debt levels are excessive
- But they know a lot about your past history with credit
- Result, the key determinants of your credit score are
 - Payment history (35%)
 - Credit utilization (30%)
 - Length of your credit history (15%)
 - Debt mixture (10%)
 - New credit applications (10%)

Payment History (35%)

- Key point: Late payments (delinquencies) hurt
 - Single delinquency could have a 50 point impact on your credit score
 - Multiple delinquencies have an even bigger impact
 - This can be very costly if you are about to apply for a loan.

Payment History (35%)

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Impact of FICO Score on \$300,000 30-Year Fixed Rate Mortgage (as of June 18, 2023)

FICO Score	APR	Monthly Payment	Total Payments
760-850	6.455%	\$1,887	\$679,440
700-759	6.677%	\$1,901	\$695,253
680-699	6.854%	\$1,967	\$707,968
660-679	7.068%	\$2,010	\$723,466
640-659	7.498%	\$2,097	\$755,004
620-639	8.044%	\$2,211	\$795,781

Source: myFICO.com

Payment History - 2

Strategy:

- Pay bills on time
- Automate your payments (via direct debits) to avoid problems
 - I do this for all credit cards, utilities, and all possible insurances
 - Still get a statement, but now it tells me roughly when withdrawal will occur
- Banking (TBD):
 - Link savings account with checking account to make sure checking account is never overdrawn

Credit Utilization (30%)

- Focus for credit score is your utilization ratio
 - Utilization Ratio = Amount Borrowed/Total Credit Available
 - Credit line includes credit card limits
 - Amount borrowed includes credit card charges not yet paid off during the “grace period.”
 - Examples: Morgan Stanley T&E policy, my parents’ credit card
 - Essentially credit bureau is checking for restraint in your borrowing.
 - *You do not need to be making payments on a loan to score high on this measure!*
 - *But you do want to avoid maxing out your cards*

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 - *You do not need to be making payments on a loan to score high on this measure!*
 - *But you do want to avoid maxing out your cards*
- Strategy: Keep utilization ratio < 20%, (or better yet, < 10%)
 - So having cards you don't use much is a good thing
 - Don't close out no fee cards if you are not using them
 - Argue against them lowering your credit limit
 - Also means you can start creating a good credit history today by getting a card and not using it much (assuming you don't have other cards)
 - Avoid “maxing out” your card

Other Credit Score Determinants

- Length of credit history (15%)
 - They like long histories
 - Another reason to keep those old no fee cards you are not using.
 - Another reason to get a card now if you want a decent score at graduation.
- Credit mixture (10%)
 - All things equal they like a variety of different kinds of credit (credit card, car loan, mortgage, etc.)
 - But I have a very high score with only credit card debt (paid in full every month)

Other Credit Score Determinants - 2

- New credit applications (10%)
 - Every application for a loan or credit card is noted on your report
 - And can count negatively on your credit score
 - So don't be a serial applier for new loans

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 - So don't be a serial applier for new loans
- Two types of credit inquiries
 - Soft inquiry:
 - When someone asks to see your credit report for a background check or when you ask for your credit report
 - No impact on your credit score
 - Hard inquiry:
 - When a bank or credit card company looks to see your report
 - These adversely affect your score
 - Issue: How should you comparison shop for a loan?
 - A group of inquiries for a single loan will count as only one hard inquiry if done in a short period of time.
 - (Generally 2 weeks for a car, 4 weeks for a mortgage)

Learning Your Credit Score

- Your credit report will not contain your credit score
- You can learn/estimate your credit score by
 - Paying a credit bureau or FICO \$20 (or so) for their score
 - Seeing if your bank provides an estimate
 - Kobliner says that CreditKarma.com will provide a free estimate
 - *Note: Scores not provided by FICO or a credit bureau will only be an estimate, but should be reasonable close*
- Be wary of using any other services to get this information
 - Lots of scammers
 - Generally a waste of money
 - Increasing use of “credit washing” results in temporary improvements
 - But this is only a short term fix
 - At worse, you have created a huge risk of identity theft
 - Remember you will be providing them with your Social Security Number, etc.

Credit Scores – Three Final Pointers

- Try to wait for your credit score to improve before taking out a loan
 - Remember, your credit history for the last two years counts the most.
- Ignore companies that offer to “fix your credit” for a fee
 - Often only do what you can
 - Benefits of “credit washing” very short term
- If you are married:
 - Remember that each of you has your own credit score
 - So cost and availability of credit may differ
 - Stuff in your name generally impacts only your report & score
 - Stuff in joint name impacts both of you
 - Implication: Payment problems on a joint card or a loan in joint name can hurt both credit scores
 - This can be a big deal when a saver marries a spender

A Basic Strategy – Up to Now

- Identify your high cost credit (like credit cards)
 - Try to refinance at lower rates (including judicious balance transfers)
 - Start paying down remaining high cost credit ASAP.
 - Goal: Turn your credit cards into payment devices, not loan sources
- Comparison shop and know credit terms before taking a loan.
 - Including APR, annual fees, prepayment terms
 - But remember to avoid negative impacts on your credit score
- Start building your credit score
 - Check credit report for errors and correct them
 - Start building a good payments history
 - Start lowering utilization ratios on your credit card debt
 - Creating a good history while in college will help you.
 - And remember that, barring adverse credit events, you may be able to make significant positive changes in a couple of years.

Digression on Car Loans

- Key Features

- Loan has a lien on the car
 - Lender has a security interest in the car and can repossess car in event of nonpayment
 - Theory: Down payments and interest rates
- Disclosure requirements
 - Banks have to tell you the APR on a car loan
 - But car dealer does **NOT** have to tell you:
 - The APR on your loan
 - If they found you a lower cost loan
 - If you are financing your purchase with a high cost loans

- Result

- Huge range of interest rates on dealer-supplied car loans (4-25%)
- Car loans are a big profit center at car dealers

Consumer Reports Study (January 2022)

- Involving 858,000 car loans
- Result 1: Similar consumers got very different loans
 - Super-prime borrowers (FICO \geq 720)
 - Rates ranged from 0-25%, (*realistically 4-25%*)
 - Prime borrowers (FICO \geq 660*)
 - Average rates ranged from 3.94%-5.93%
 - About 3% of group got rates of 10%-25%
- Result 2: 96% of dealers did not verify income
 - Which means they were not checking to see if you could afford the loan

** Note: I do not consider a FICO score of 660 a prime borrower.*

Cost of Different 5-Year \$30,000 Car Loans

APR	Monthly Payment	Total Payments
4%	\$552	\$33,150
10%	\$637	\$38,245
25%	\$881	\$52,832

Source: BankRate Auto Loan Calculator

Note the implied costs of the “low credit or even no credit” car lots.

Don't Bargain Over The Monthly Payment

Cost of Various \$30,000 Car Loans

APR	Monthly Payment		Total Payments	
	3-Year Loan	5-Year Loan	3-Year Loan	5-Year Loan
4%	\$886		\$31,886	
10%	\$968		\$34,849	
25%	\$1,193		\$42,941	

Source: BankRate Auto Loan Calculator

Don't Bargain Over The Monthly Payment

Cost of Various \$30,000 Car Loans

APR	Monthly Payment		Total Payments	
	3-Year Loan	5-Year Loan	3-Year Loan	5-Year Loan
4%	\$886	\$552	\$31,886	\$33,150
10%	\$968	\$637	\$34,849	\$38,245
25%	\$1,193	\$881	\$42,941	\$52,832

Source: BankRate Auto Loan Calculator

What Can You Do About High Cost Car Loans?

- Before buying
 - **Comparison shop car loans as well as cars!!!**
- After buying
 - You can usually pre-pay the debt (*assuming you have lots of spare cash lying around or you have generous parents*)
 - **But you will NOT be able to refinance it!!!**
 - **So do NOT make the mistake of signing a loan document without knowing it is a fair deal**

How to Protect Yourself

1. Research car values before you buy
 - By comparison shopping
 - By checking out websites like www.Edmunds.com
2. Comparison shop car loans before you go to the dealer
 - Get a firm commitment from a bank (or several banks)
 - Or check bank websites if you know your credit score
 - See if dealer can match or better that quote
 - Note: you can learn a lot from that bank commitment (including your credit rating, their idea of your debt capacity, and the monthly payment on their loan)
3. Beware of the “after-market” sale
4. And never never never bargain over the monthly payment
 - Bargain first on the sale price of the car
 - Bargain next on the financing cost of the car (the APR, not the payment)