Dear Borrower,

**CREDIT.** It's the six-letter word we both love and hate. It stretches our financial resources when we are short of cash, and helps us achieve our long-term personal goals when we use it prudently.

Changes in consumer lending over the past several decades have made it much easier for borrowers to qualify for credit and to exercise this newfound financial power even before starting their first full-time jobs. This "democratization" of credit means it's more important than ever for borrowers to arm themselves with knowledge and build sound financial management skills in order to maximize the benefits and minimize the risks of these new opportunities.

The information and advice in the *LendingTree Guide to Smart Borrowing* will provide a roadmap for making prudent financial decisions throughout the distinct phases of your life—from the student just starting out to the senior enjoying her "golden years."

Understanding the differences between "bad debt" and "good debt" is a critical first step along the winding path to financial freedom. "Bad debt" is debt that you don't fully understand, or unnecessary debt that you use to pay for living beyond your means. "Good debt" helps you achieve a goal or leaves you with a sound financial asset.

As you learn the skills of smart borrowing, you may be surprised at how much more confident you will become at managing your debt and choosing the best sources of credit for you, and also how passionate you may become in passing on this newfound knowledge to friends and family. Empowerment tends to energize people!

Remember, credit is neither good nor bad. It's how you use it that determines its benefits or disadvantages. Becoming a smarter borrower is a lifelong journey, and it's never too early—or too late—to start. It is our hope that you will choose to borrow wisely. But in the end, the choice is yours.

Robert D. Manning, PhD Professor of Finance, Rochester Institute of Technology Author, *Credit Card Nation* 

## **Using Credit** Wisely

Credit can be a powerful financial tool, if you use it the right way.

If you've ever asked a friend to spot you a few dollars for lunch, charged something to your credit card, or paid for something in installments, you've used credit. Credit is simply your ability to borrow money—or, in other words, it's the trust lenders are willing to put in you to repay your debts.

These days, it's easier to get credit than ever before. The process of applying and qualifying is fairer and more accessible than it was in the past, giving more people the opportunity to enjoy the advantages of credit. Unfortunately, that access also means that you have more chances to use credit irresponsibly, which can cause serious damage to your financial life.

That doesn't mean you should avoid using credit, because by using it wisely you can do much more financially than you might otherwise—pay for a car, a home, a college education, and much more. To take advantage of all that credit has to offer you, you need to learn to use it the right way, and to avoid the pitfalls that can land you in dangerous debt.

## WHAT YOU CAN DO WITH CREDIT

There are two main ways to use credit wisely: to manage your short-term cash flow or to help you achieve your larger goals.

Credit cards have become an almost indispensable tool for many people, adding flexibility to short-term budgeting. It's important to be careful about short-term credit use, because your everyday credit use is the basis for your credit history, which plays a huge role in your financial life.

A good credit history can give you more than just short-term budgeting flexibility. It can give you long-term financial options. As you plan for what you want to do with your life and your money now, tomorrow, and in the future, you'll be better equipped to achieve your goals if you have a financial strategy to make the most of your time and financial resources.

For example, you may have plans to take a vacation next year, buy a car, buy a new home, open or expand your own business, send your kids to college, and retire. But you wouldn't want to pour all your money into vacations and have none left for your other goals. So you need to find out how much you need to set aside for

each goal, and in what manner.

Often the best way to meet a goal is through saving and investing, but for some big goals the best way may be to use credit.

## SMART DEBT VS. DUMB DEBT

You may think that being in debt is always bad, but that's not necessarily so. Sometimes it may be advantageous to borrow, such as with a mortgage or a student loan. Smart debt leaves you with an asset that's worth the cost of the credit you used to get it. To borrow the smart way, you need to understand first whether using credit will help you, rather than harm you. You'll need to grasp what debt actually costs, how that cost

grows over time, and how the way you use credit now affects your ability to do so in the future.

Some debts are just plain dumb. It's



Getting a mortgage that allows you to build equity quickly and pay off your debt faster

Buying a car with a large down payment and a smaller loan that you'll pay off in just a few years

Borrowing against your home to help your children pay for college

TERM GOALS pay for with cash, but remember:

You do have to pay eventually. And if you take your time repaying, things can end up costing much more. One sign of dumb debt is when you're still paying for something long after you've stopped using it.

TERM GOALS

tempting to

use credit to buy

things you can't afford to

When you don't understand how the credit product you're using works, whether you can afford it, and

what the consequences are of using credit, you run the

**DUMB** 

Buying a house you really can't afford because you're offered a mortgage with a low monthly payment

Buying a car you'll drive for 5 years, but taking out a 7-year loan to do it

Borrowing against your home to consolidate your credit card balances—then

risk of making bad debt choices that can plague you for years. To pay down your debts, you may have to live on a restricted budget for a long time. It can mean postponing or giving up some of your goals, scraping by in your budget, and even suffering emotional stress, all because of poor credit management.

Smart borrowing involves planning. It involves asking yourself whether you're better off saving and paying cash later, rather than using credit now and paying the interest. It means understanding the total cost of a loan you've taken out, not just how much you'll be paying on it per month. It means coming up with a repayment plan and sticking to it. By learning how to be smart about your credit choices now, you'll spare yourself the trouble of wising up too late.

NO CREDIT, NO SERVICE

Credit cards are required for many transactions these days, as a verification of your identity and a guarantee of your responsibility, such as when you check into a hotel, sign a cell phone agreement, book an airplane ticket, or rent a car.

racking up more charges on the cards

## **Credit Reports** and Scores

You're being graded all the time on how you use credit.

Information on your credit habits is being collected all the time, compiled, and sold to parties who have the right to request it.

Your credit history can have a huge impact on many areas of your life, beyond just your ability to borrow money and the interest rates you pay. Because of this ripple effect, it's more important than ever to keep close tabs on what your credit history says about you.

### THE BIG THREE

There are three national credit bureaus— Equifax, Experian, and TransUnion—which collect information on the millions of people who use credit. They get information from credit applications, the public record, and lenders who report information about credit accounts. Then the bureaus compile the data in **credit reports** and sum it up in **credit scores**.

## KNOW THE SCORE

Your credit score is one of your most important financial assets. It's a three-digit number that distills what lenders want to know about your use of credit from the detailed information in your credit report. Your credit score tells the lender how likely you are to repay the debt, and having it available speeds up the approval process.

The most popular credit scoring system is known as FICO, named after Fair Isaac Corporation, the company that developed it. It grades your credit on a scale of 300 to 850, with 300 being the worst and 850 being ideal.

## TIP: KEEPING TABS ON CREDIT

Since you get one free disclosure per year from each credit bureau, you can keep track of your credit for free throughout the year by requesting them one at a time, one every four months.

## CREDIT REPORT

## WHAT'S ON YOUR REPORT?

## Personal information

- Your full name and previous names you've used
- Social Security number
- Date of birth

- Current and past addresses
- Current and past phone numbers
- Current and past employers

## **Credit history**

- Open and closed accounts
- Date accounts were opened
- Credit limits and loan amounts
- Outstanding balances

- Payments and payment patterns
- Whether others are also responsible for debts, such as joint accountholders or loan co-signers
- Inquiries

### Public record

- Overdue child support payments
- Tax liens

Bankruptcies

## CREDIT SCORE

Your FICO score is based on numerous factors, of which the following are the most critical:

- Your history of paying on time
- The amount you owe on revolving balances, including the proportion of available credit used
- The length of your credit history
- The amount of new credit you have
- The types of credit you use



## **MAKING AN INQUIRY**

Lenders use credit scores to decide whether to offer you credit or approve your application. Other businesses, such as retailers, insurers, potential employers, and landlords, are also allowed by law to see your credit report. In other words, not only does your credit affect your cost of borrowing, but it also affects your ability to get an apartment, a job, or insurance. When one of these parties asks to see your information, the request shows up on your report as an inquiry. Too many inquiries can have a negative effect on your credit score, since lenders get nervous if it looks like you've been requesting credit lines from several different places in quick succession.

Fortunately, these factors are all under your control. The most important is on-time payments. If you regularly pay on time, your score is likely to be strong. And recent payments affect your score more than old payments.

What difference does your score make? Quite a lot. The better your score, the more creditworthy you appear to lenders, who'll be more willing to offer you attractive terms and rates. A score over 720 is generally considered an indication of a strong credit history. A score at 620 or below is considered poor, or what the industry calls **subprime**.

You may not think your credit score is that important, but even small differences in credit scores affect the interest rate you pay. An interest rate that's higher by as little as a quarter of a percentage point doesn't sound like much but

could cost you a lot more money over time. For example, 7.25% fixed interest on a 30-year \$100,000 loan would cost \$21,764 more over the life of the loan than would 7.00% fixed interest for the same principal amount and time frame.

Fortunately,

inquiries from lenders who want to offer you preapproved credit, such as credit card offers in the mail, don't show up on your report. You're also not penalized for shopping around for car loans or mortgages, since multiple inquiries of these types within 45 days are treated as a single inquiry. Your score also ignores car and mortgage loan inquiries from the past 30 days, so if it takes you a month to find the right loan, you won't be penalized for rate shopping. Those inquiries that do get reported stick around for two years.

## WATCHING THE DETECTIVES

As you can imagine, the job of compiling all this data is gargantuan. Naturally, mistakes creep in. For example, people with similar names or Social Security numbers sometimes get confused in the data systems: Alice Chan's late credit card payment from April may show up erroneously on Alice Chen's report and make her look bad.

That's why it's a good idea to review your credit reports at least once a year, so you can contact the bureaus in writing to correct anything that's wrong. It's also a way to check if you've been a victim of identity theft, since identity thieves frequently work by opening new credit accounts in other people's names, using stolen personal information. In fact, if you are turned down for credit or for a job, you are entitled to a free credit report from the credit reporting company that supplied the information that worked against you.

Since September 1, 2005, a law known as the FACT Act entitles everyone in the US to one free credit file disclosure per year from each of the three credit reporting bureaus. Although these disclosures are commonly called credit reports, they differ slightly from the reports that the bureaus sell to lenders. You'll get more information on your disclosure, including inquiries for preapproved credit offers, than on the credit report distributed to others.

You can request your free disclosure at www.annualcreditreport.com. To get more than one report a year you can pay \$9.50 each, the price set by law, or subscribe to one of the credit monitoring services offered by lenders and the credit bureaus to people who want to keep closer tabs on their credit, usually for a quarterly or annual fee.

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## **Getting Good Credit**

Slowly but surely, you can build a good credit history.

Since the quality of your credit is so important, you're probably wondering how to make yours better—or how to maintain it, if it's already in great shape.

Good credit isn't something you can achieve quickly. Instead, it's the collected sum of good habits and smart decisions over time. You just need to know what to do, and be committed to doing it.

## STARTING SMALL

It may seem like a conundrum: You need a credit history to get credit, but you can't get credit without a credit history. What's a new credit user to do?

There are ways to get credit even if your credit history is lacking. For example, **secured** credit cards let you borrow up to an amount you've deposited with the bank as security, and over time your credit limit can grow. You can also look for **charge cards**, which don't allow you to carry a balance, and instead require you to pay in full every billing period.

These kinds of credit aren't as convenient or flexible as other types, and the amounts you'll be allowed to borrow will be low. But because they're so limited, you'll learn how much you can afford to borrow, and you'll get in the habit of paying your debts in full and on time. You'll

learn how to handle credit, and you'll show lenders that you're capable of taking on more.

Even if you qualify for credit, if you're having trouble managing it responsibly, you may want to switch to using only charge cards to rein in your spending. One thing to check when you apply for a charge card is

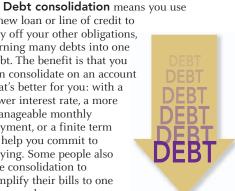
whether the card issuer reports your use to the major credit reporting companies. Cards that don't won't help you build a credit history.

## **DEALING WITH DEBT**

Above all, the most important factor in your credit is your history of on-time payments. If you're having trouble making those payments, you might need a better plan for paying off your debt.

a new loan or line of credit to pay off your other obligations, turning many debts into one debt. The benefit is that you can consolidate on an account that's better for you: with a lower interest rate, a more manageable monthly payment, or a finite term

to help you commit to paying. Some people also use consolidation to simplify their bills to one per month.



## THE POSITIVE

- On-time payments
- Established history of using credit
- Older accounts
- Low balances on revolving accounts
- Small number of

accounts

Charge

Card

Secured

Card

## THE NEGATIVE

- Delinquent payments
- High debt
- Short history of using credit
- Newer accounts
- High balances on revolving accounts
- Accounts over 120 days
- Many recent inquiries
- High number of open accounts
- Accounts closed by the lender as uncollectible
- Bankruptcies

## **BEWARE CREDIT QUACKS**

You may have seen advertisements for credit doctors or credit repair services, offering to fix your credit—but without requiring changes in your behavior. Be careful: These are often con games designed to charge you high fees for ineffective or illegal schemes.

Instead, if you need help with credit, seek the services of a nonprofit credit counselor. You can contact the National Foundation for Credit Counseling. To find the closest member agency call 800-388-2227 or go to their website at www.nfcc.org. Their fees are modest, and they operate in all 50 states. They'll help you look at your budget, your debts, and your spending habits, and find ways for you to improve your credit and your finances overall.

**Debt acceleration** means you pay off your debt faster by paying more.

It sounds simple, but it takes commitment to achieve. You'll need to find extra money in your budget to put



toward reducing debt. It won't work if you pay too aggressively and find yourself out of cash for daily necessities. But the right balance can get you out of debt faster and more cheaply.

## ARE YOU IN TROUBLE?

If any of these warning signs of bad credit applies to you, you may have a credit problem:

- Late or missed payments
- Only paying the minimum
- Near or over the limit on credit
- Using cash advances for everyday living expenses
- Recently turned down for credit
- Your card is declined for a purchase
- Calls and letters from lenders or collection agencies
- No savings



## **RAISING YOUR SCORE**

There's always a second chance in the world of credit. Most negative information is removed from your credit report after seven years. The exceptions are certain types of bankruptcies, which show up for 10 years, and unpaid tax liens, which are listed for 15 years.

If you've made credit mistakes before, you can use fresh, positive information to offset old, negative information. Lenders weigh recent behavior more than past behavior, so you'll see your scores rising as your new patterns establish themselves.

Here are some things to do to get started:

- 1. Pay on time. You should always send at least the minimum by the due date. A pattern of on-time payments is the most important factor in your credit. You might want to consider paying electronically or setting up automatic payments from your checking account to ensure that payments arrive on time.
- 2. Reduce outstanding debt. Owing a lot on revolving accounts, including credit cards, looks bad to lenders. If your balances take up a high percentage of the available credit on your revolving accounts, paying down some of your debt can bump up your scores.
- 3. Don't open unnecessary accounts. A high number of open accounts, even without balances, can have a negative effect on credit. If you're offered a discount for opening a store credit card, think about whether you want that account and inquiry on your report.

## CONSOLIDATION **CAUTION**

If you do consolidate your debt, don't use it as an excuse to run up more debts on your newly

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cleared credit cards.

## **Loans and Revolving Credit**

You can borrow money all at once—or just as you need it.

There are two main ways for you to borrow money: through loans, which let you borrow a one-time amount, and **revolving credit**, which gives you the right to use and re-use an **open line of credit**.

## **HOW LOANS WORK**

Loans have a long history. In fact, you've probably made a loan yourself at some point in your life—such as giving someone \$10 for lunch and having them pay you back the next day. With a loan, the lender or creditor gives you, the borrower or debtor, use of a lump sum of money, to be paid back after a set time, usually with interest added to compensate for the time the money's been in your hands.

Most loans are repaid through regular installment payments each month, scheduled to end at a time set by the agreement between you and the lender. Once the total amount is repaid, the loan ends. If you want to borrow money again, you have to apply for a new loan.

## USE THE RIGHT TOOL FOR THE JOB

Because of the way they're structured, loans and revolving credit are used for different kinds of credit needs.

Loans typically finance large, one-time purchases. They allow you to spread payments out over time, helping you fit important but expensive purchases like college tuition, a home, a car, or large household appliances into your budget.

Revolving credit, on the other hand, is used on an ongoing basis to give you flexibility in your budget. You can use revolving credit to pay for something before you have the money in the bank, such as while you're waiting for a paycheck to clear. Some people use revolving credit to simplify payments and track their buying habits, by charging everything on a credit card, verifying the items on the bill when it arrives, and making one payment per month.

Because you don't have to wait for approval every time you use revolving credit, you can also use it as a quick and easy way to finance large purchases that fit within your credit limit. You'll have more flexibility about repaying, too—but also more opportunity to rack up substantial finance charges over time.



# TYPICAL LOANS TYPICAL REVOLVING CREDIT LINES Output Output

%

Finance charges are the dollar amount of interest and any fees you pay when you use credit and have an outstanding balance. **Interest** is the rate at which the finance charge is calculated, as a percentage of the amount you owe.

## HOW REVOLVING CREDIT WORKS

The form of credit people use most often is the credit card, a kind of revolving credit. Even though revolving credit is used in everyday financial transactions, it's a little more complicated to understand than a loan.

Instead of re-applying for credit every time you need to borrow money, revolving credit lets you apply just once for a line of credit, which is an amount you can use on demand, as needed.

You pay no interest—although you may pay fees—until you actually use the credit. Then you only pay interest on the outstanding balance.

Unlike loans, revolving lines of credit have no set timetable for repaying debt.

There is generally a minimum payment due each month, based on the balance, but you're free to pay more. So you can pay a lot one month and the minimum the next month if you choose. Just remember that the longer you take to pay, the more interest you'll owe. In most cases, too, if you don't pay

at least the minimum when it's due, you'll be

1. First the lender, usually a bank or other financial institution, approves a credit limit for you. That limit is the maximum you're allowed to owe on the account at one time, based on factors like your income, your assets, and your credit history.

3. Any amount you repay is once again available for you to use. That's why this type of credit is said to revolve: It doesn't end when it's repaid, but can be used over and over.

2. You can borrow up to your limit. The amount you borrow is subtracted from the amount of credit available, as is any finance charge you owe.

charged a late fee and the interest rate you pay on your line of credit may be increased.

## DON'T GET STUCK IN THE REVOLVING DOOR

Revolving credit is more convenient and accessible than loans, but it's also easier to misuse. Debt on revolving accounts has the potential to stick with you a long time if you're not careful about repaying quickly. For financing large purchases, the inflexibility of loans can actually be helpful, because they're designed to limit costs and are a predictable budget item, ending on a set schedule.

In contrast, revolving credit may tempt you to pay back debt more slowly, simply because you can. Meanwhile, finance charges will accrue and the debt will remain a burden. Carrying high balances on revolving accounts can also lower your credit score, affecting your ability to use credit in the future.

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## The Cost of Credit

Do you know what it will cost you to borrow?

The cost of credit comes in two forms: as onetime fees, and as **interest**, or the time-cost of what you borrow. Although fees are frequently difficult or impossible to negotiate, you can often control how much you pay in interest by controlling the time it takes you to repay your debt and by keeping your credit score low.

## SIMPLE

## TIME IS INTERESTING

Borrowing is a little like renting someone else's money. You give it back eventually, but you also pay a cost for the time you had it. In credit, that time-cost is the interest.

Interest is charged as a percentage of what you've borrowed, per year—for example, 10% annual interest. But you also have to know if you're dealing with simple or compound

Simple interest is charged only once. At 10% simple annual interest, borrowing \$500 for one year costs \$50 in interest. Over two years, it costs \$100.

But compound interest is more common and potentially more expensive. With compound interest, interest is charged over and over: monthly, weekly, even daily, depending on the terms of the contract. Many credit cards and loans, for example, charge interest every month. To get the monthly rate, divide the annual rate by 12 (the number of months in a year).

### THE POWER OF COMPOUNDING

Charging 1% compound interest per month is not the same as charging 12% simple interest per year.

Suppose you had a \$1,000 loan that you were going to pay back all at once, with 12% annual interest, at the end of a year. If you were paying simple interest, you'd pay \$120 in finance charges. If interest was compounded monthly, the finance charges would be \$126.83.

It's a little more because every month the finance charges are added to the balance, and interest is charged on the whole amount the next month. It seems like a small difference, but the effect magnifies over time. It's especially important for credit cards, since you control the time period and the speed with which you pay off your balance. In contrast,

fixed-rate loans are designed to control costs—so you'll know how much interest you'll pay over the life of the loan. One reason that people run into

> trouble with compound interest on credit cards is that minimum payments tend to be low, barely

covering the finance charges and fees and paying off very little principal. So paying the minimum

is the slowest and the most expensive way to pay.

For example, suppose that the minimum payment for your credit card was calculated as 4% of the

balance. If you had a balance of \$1,000 at 15% annual interest, paying just the minimum would take you 6 years and 8 months to get to zero, assuming you stop using the card for other purchases. You'd pay \$392.53 in finance charges—almost 40% of what you borrowed.

If you keep using your card while you're paying off your balance, the minimum payment might not even pay for the interest, putting you in danger of increasing rather than decreasing your debt over time, and paying interest on interest—on interest.

## NO FEES?

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Frequently, you'll find lenders who are willing to offer you a loan or a line of credit without fees, or with reduced fees. Before you take them up on their offer, it's a good idea to compare the fee-free option to the regular one with fees. Sometimes you'll pay higher interest for no-fee loans, which can cost more in the long run. Also note that in some instances, not all fees are waived, such as mortgage tax and title insurance. Make sure to read the fine print for the details.

So remember: With compound interest, the COMPOUND
INTEREST longer it takes to pay a debt, the more expensive it becomes.

## **UNDER-STANDING** APR

You've probably seen annual percentage rates (APRs) advertised for mortgages, loans, and credit cards. For credit cards and other revolving lines of credit, APR is the compound interest rate, and doesn't include any additional fees. But for loans, APR includes both the interest rate and the

fees and charges, such as loan-processing fees and charges for credit-related insurance.

To give you an idea of how it works, a loan may have an APR of 6% but an interest rate of only 5.5%. That missing 0.5% APR represents fees and charges that you'll probably pay up front. Your monthly payments will be based on the 5.5% rate—generally compounded monthly.

\$\$\$\$\$\$\$\$ Loans and lines of credit with variable interest rates frequently base their interest rates upon movements in the prime rate. For example, a credit card with a variable rate may say that the rate you'll be charged will be the prime rate plus 10.99%.

> But what is the prime rate, and who's lucky enough to get it? Banks lend at the prime rate to their most preferred customers, who have the lowest risk of defaulting on their debt—generally large corporations. Most everyone else gets charged a set level above the prime rate called the margin, based on your credit history and score.

## ANNUAL PERCENTAGE RATE (APR) = \$\$\$\$\$\$\$\$\$ **PLUS FEES**

## **APRs AND ORANGES**

Lenders are required to disclose both the interest rate and the APR for a loan. The law is meant to make sure that lenders don't lure you in with low interest rates and hit you later with hidden fees. For the most part, APR is a good place to begin comparing loans, but it's not always perfect.



The law does require that lenders reveal all costs involved before a loan is made. You'll get the details in a document called the truth-in-lending disclosure. It tells you nterest exactly what you'll pay for a loan, both in terms of Rate APR, finance charges, and

total dollar amount.

11

## Loans

Some of the most important things in life require a little financing.

Perhaps you've heard the joke, "How do you eat an elephant?" and the answer, "One bite at a time." The same principle can explain what loans let you do-pay for something you couldn't otherwise manage, by letting you pay bit by bit.

Normally, when you want something you can't afford, the best thing to do is to delay the purchase until you've saved up enough to pay in full. But for certain things—for example, your home, college education, car, or major household appliances—it's impractical or undesirable to put off buying. Instead, you take out a loan. You can also use loans as part

of a financial strategy to pay off other debts, to make investments, or for other goals.

Regardless of what you're using the loan for, there's a basic structure to the way loans work. You borrow principal and agree to pay it back over a stated length of time, plus interest.

Within that framework are many variations, depending on the details of your loan. If you familiarize yourself with the options, you'll have a better shot at finding the loan that's best for you.

## **TYPICAL LOANS**

- Home loans
- Auto loans
- Education loans
- Store installment payment plans
- Mobile home loans
- Boat loans
- Personal loans

## **DECISIONS. DECISIONS**

You'll have a number of choices to make when shopping for a loan:

- Will you pay in installments, as a lump sum, or with a balloon payment?
- Is the interest fixed or adjustable?
- Is the loan secured or unsecured?

## RIDE THE BALLOON

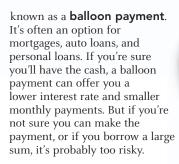
Another way to schedule repayment is to pay interest only during the loan term and make a large final payment of the whole principal,

### **AMORTIZATION**

In the language of loans, amortization refers to the way your debt decreases and ends on schedule as you make payments. In a fully amortizing loan, you typically pay monthly, in amounts calculated to repay your total principal plus interest by the end date. A longer loan term means smaller payments, but higher costs overall. A shorter term means larger payments but lower costs and a faster end.

While a long term with low monthly payments can help your cash flow, be sure to consider the total cost, which will be higher. For example, if you had a 3-year \$25,000 car loan at 7% interest, you'd pay a total of about \$2,789 in interest. But if you extended the loan to 6 years, you'd pay about \$5,688 in interest—\$2,899 more.

Each payment typically covers some principal and some interest. In most cases, you'll pay mostly interest at first, since lenders like to collect their profit early. Then you'll pay more principal with each payment, until by the end, you're paying little interest and almost all principal.



## THE RIGHT RATE

Lenders offer either fixed rates of interest, which are set at the beginning of the loan and remain constant until the end, or adjustable rates, which are reset periodically based on current rates. Sometimes you have a choice, and sometimes you don't.

If you can choose, which is best? That depends on what you anticipate will happen to interest rates. It's smart to pay attention to the financial news, where interest rates are reported regularly. If rates are low now, a fixed rate can protect you from future increases. But if rates are high now, an adjustable rate may let you benefit from a potential future fall in rates.

## **SECURED LOANS**

You might be approved for lower rates or higher loan amounts if you can provide **collateral**—an asset that a lender can take as payment if you don't pay back your loan. Loans



For example, suppose you had a \$200,000 mortgage, amortizing over 20 years at 6% fixed annual interest. Your payments would be \$1,432.86 per month. See how interest and principal payments change as time goes on.

MONTH	HOW PAYMENT IS DIVIDED	TOTAL PAID SO FAR	BALANCE
1	Interest: \$1,000 Principal: \$432.86	\$1,432.86	\$199,567.14
25	Interest: \$944.96 Principal: \$487.90	\$35,821.50	\$188,503.57
50	Interest: \$880.17 Principal: \$552.70	\$71,643.00	\$175,480.45
100	Interest: \$720.08 Principal: \$712.78	\$143,286.00	\$143,303.56
200	Interest: \$327.34 Principal: \$1,105.53	\$286,572.00	\$64,361.58
240	Interest: \$7.13 Principal: \$1,425.73	\$343,886.40	\$0

backed with collateral are called secured loans. For example, mortgages are secured by your home and car loans by your car.

As attractive as these loans are, before committing to one you should consider the possibility that you'll have to part with your asset if you don't make your payments.

## SMALL LOANS, BIG COSTS

Here are a couple of loans to avoid if you can:

Tax refund anticipation loans are short-term loans with extremely high interest rates, made in advance of your tax refund. Tax preparers often offer them, as do a host of other lenders.

Title loans use your car as security for a shortterm loan. The amount you borrow is usually under \$1,000, but if you fail to pay, your car is repossessed—even if it's worth more than the

## **BORROWING FROM YOURSELF**

If you've got money in a 401(k) or similar retirement plan or you own a permanent life insurance policy, you may be able to borrow from your own account and pay yourself back.

It may be easy to qualify for these loans, but there could be serious consequences if you don't repay. For instance, unpaid loan balances against your insurance policy reduce the amount of the death benefit, and unpaid 401(k) loans become early distributions if you leave your job. This means income taxes are due, plus a potential 10% tax penalty if you're younger than 59 1/2. Consult a tax adviser for details on your particular situation.

## **CROSS THAT BRIDGE**

Bridge loans are high-interest, short-term loans designed to carry you over until you receive an expected payment or a more permanent loan. For example, you might use a bridge loan to buy a new home while you're selling your old one. You generally pay bridge loans off in one lump sum payment, rather than installments.

## NO CREDIT, NO PROBLEM?

Beware of people who claim they can find a lender willing to make you a loan, no matter what your credit history—if you pay an advance fee. If it is not a trustworthy company, you'll pay the fee and never get your loan.

## Mortgages

One of the best times to borrow is when you're buying a home.

Few people have enough money in the bank to pay for a new home in full. Even those who do rarely choose to pay cash. So for most people, buying a home means a mortgage. Fortunately, a mortgage is a perfect example of smart credit use.

With a mortgage, you get the chance to buy and live in your own home, while paying only a fraction of the price up front. As you pay it off, the value of your ownership stake-known as your home equity—also increases. Since your home is such a valuable asset, a mortgage can be an exceptionally good value, especially if, as in most cases, the interest is tax deductible. You should consult your tax adviser about your own situation.

## APPLYING FOR A MORTGAGE

Most lenders use a standard application. The most important elements are these:

- Your income
- Your assets, including investments and retirement accounts
- Your expenses
- Your debts
- Your credit score.
- Your loan-to-value (LTV) ratio If one lender turns you down, it's worth trying another. Lenders look at the same information but often assess it differently.

## **PAY STUB \$**

1-800-555-TREE

## PREQUALIFICATION AND **PREAPPROVAL**

Usually, you find the home you want first and then apply for a mortgage. But what if you can prequalify or be preapproved?

Lenders who offer prequalification will give you an estimate of how much home you'd qualify to buy. Lenders who offer preapproval review your application before you shop. Then they tell you if you're approved and the amount. Keep in mind, though, that just because a lender decides you qualify to borrow a certain amount doesn't mean you should borrow that much. That depends on your total financial situation.

In hot housing markets, you might need preapproval to have your offer seriously considered. Preapproval can also give you an edge in negotiations, since sellers like to be certain that a deal will go through. But if you're not certain you're buying, the cost might not be worth it.

## AT ANY RATE

• Fixed-rate mortgages let you borrow at an interest rate that stays constant over the life of the loan.

## WHAT LENDERS ARE LOOKING FOR

- A history of full-time employment
- A good credit score
- No more than 28% of total income needed for mortgage PITI (principal, interest, taxes, and insurance)
- No more than 36% of total income needed to pay total debt, including mortgage and credit cards



DEBT

**CREDIT CARD** 0000 000 0000

- Adjustable-rate mortgages, known as ARMs, have rates that move up and down based on general interest rates.
- Hybrid mortgages offer fixed rates for a time, and then switch to adjustable rates. One variation, the 5/1 ARM, charges a fixed rate for five years and afterward adjusts your rate once a year. Hybrids may offer lower rates initially than fixed-rate mortgages. Since most borrowers move or refinance within seven years, a hybrid might let you pay less interest overall.

## PAYING POINTS

Points are interest paid up front to lower the rate over the life of your mortgage. One point is 1% of the total loan amount. If you have the cash and plan on holding the mortgage a long time, paying points may make sense. But if you'll refinance or move soon, you might want to skip the points if you can, and take the higher rate.

## WHAT YOU'RE LOOKING FOR

- Lowest APR
- Lowest closing costs
- Faster way to build equity



## THE CLOSER

In addition to interest, mortgages have a number of closing costs, which you pay when the deal is finalized. These include origination fees, charges for getting your credit report, title search and insurance, and so forth. They usually add up to between 2% and 6% of the total mortgage.

Closing costs may not be finalized until closing. Lenders are required to give you a good faith estimate (GFE) within three days of receiving your application. It gives you a line-by-line estimated breakdown of what you can expect to pay.



## **BEWARE THE TEASER**

Advertised rates and quick quotes aren't guarantees. The rate you actually get depends on your credit application and the terms of the mortgage you choose. That's why you're better off comparing real offers from multiple lenders.

## PAY LESS NOW, MORE LATER

Usually, each payment covers some principal and some interest. Interest-only mortgages let you pay no principal at all, generally for a period of five to ten years. This means smaller monthly payments initially, but higher payments later.

Interest-only mortgages let people take larger mortgages in anticipation of higher future income. But some people borrow more than they can afford when the payments go up—which can cause a budget crunch later.

## **REFINANCING: WHEN AND WHY?**

If interest rates fall substantially, you may find yourself paying more on your existing mortgage than the rate for new mortgages. That's when **refinancing**—using a new mortgage to pay off your old one—may seem attractive.

When rates are falling, an often cited rule is that you should refinance if you can lower your rate by at least 2%. When rates are rising, it might make sense to refinance from an ARM to a fixed-rate mortgage if you plan to stay in your home for a long time. But what really matters is whether you'll save money.

Refinancing means paying fees and closing costs all over again. If you move soon afterward, your savings at the lower rate might not cover the costs. So you should consider both whether the new rate is low enough and if you'll stick around long enough to make it count.

Furthermore, if you've had your mortgage for a while, you may have paid most of the interest. When you refinance, you'll start paying mostly interest again—taking longer to build equity.

Some people who have substantial equity in their homes, often because the market values have gone up, use cash-out refinancing to get low-interest credit by replacing their mortgage with a larger one. For example, if you had a \$75,000 mortgage and refinanced with a \$100,000 mortgage, you could take the \$25,000 difference as cash, usually at a lower rate than with a home equity loan. It might be smart to use cash-out refinancing for something with long-term value, like home improvements or college costs, but it's not so smart to use it for things you don't really need.

## CONTROL CLOSING COSTS

- Many people take a higher interest rate in exchange for zero closing costs. But paying at closing can save you money in the long run.
- You may be able to negotiate fees that the lender controls, such as application, origination, processing, and underwriting.
- Look at costs for third-party services, such as attorney fees for title search and document preparation, since lenders sometimes mark these up.
- Don't understand a fee? Ask about it. Lenders sometimes throw in extra fees to pad their profit. If you question one, they might take it
- Research typical closing costs in your area, so you know if what you've been cited is reasonable. If possible, ask for good faith estimates before you apply, so you can compare.

www.LendingTree.com

## **Using Home Equity**

Borrowing against home equity could let you have your cake and eat it too.

As you repay your mortgage, you'll build equity, which is the part of your home that you actually own. If you sell your home, your equity is the cash left over after you pay off your mortgage. But you can even use your equity while you're still living in your home, because you can borrow against it.

Total value of your home

Remaining balance due on mortgage

= HOME EQUITY

## **BUILDING EQUITY**

The amount you owe on your mortgage reduces your home equity. To get a head start in building equity, you can make a bigger down payment, or you may be able to pay off your mortgage faster.

Mortgage payments are calculated to completely pay off all the principal and interest that you owe by the end of the term. This process of gradually ending your debt on schedule is called amortization. In the beginning, you'll pay mostly interest, but as time goes on you'll pay less interest and more principal. Paying

interest more quickly means starting to pay principal earlier, which speeds up the rate at which you're building equity. You might be able to build equity faster by making additional principal payments, too. Some mortgages charge a

prepayment penalty if

you repay your loan within the first few years, so be sure to check the specific terms of your mortgage.



What you

owe

## KEEP AN EYE ON THE MARKET

One of the reasons it's important to look closely at the neighborhood you move into is that the market value of your home also affects your equity. If your neighborhood has a good school system or other attractive features, your home's value could go up, increasing your equity.

But if your home drops in value, you'll lose equity. This could happen if home prices in general fall because demand has fallen or because interest rates rise, making mortgages more expensive.

## **CONVENIENT CREDIT—WITH A FEW CATCHES**

Because the collateral is so valuable, home equity borrowing is one of the easiest, most accessible forms of credit. You can borrow a lot—usually up to 80% of your equity—at some of the lowest interest rates available. Plus, the interest is frequently tax deductible—though you'll need to check with your tax adviser to be sure.

There are a few catches. Most home equity lines of credit have adjustable interest rates, and might become more expensive later. Borrowing reduces your equity until you repay the debt. And if you default, meaning you miss payments, you could lose your collateral, which means losing your home.

Many lenders will renegotiate before they foreclose on your home, but it's best never to run the risk. The smart approach is to borrow against your home only when you know you can repay, and when you have a good reason.

to see if the improvements you've planned are likely to increase the value of your home enough to be worth the cost.

To consolidate high-interest debt. If you're paying high interest rates on other debts, such as credit card balances, you could consolidate your debt with a low-interest home equity loan. Consolidation is a smart move when it helps you plan your way out of debt and when the interest is tax deductible—but it's not smart if you go back to charging up credit cards you've paid off. Then you're in twice as deep.

## LOANS VS. LINES OF CREDIT

There are two ways to borrow against your equity: loans and lines of credit.

## Home equity loans

Also known as second mortgages, home equity loans let you borrow a lump sum, usually at a fixed interest rate. You pay in installments, as with a mortgage.

And like a mortgage, a home equity loan may involve closing costs. To win your business, some lenders may forgo the closing costs or even offer teaser rates—low rates for an initial period. If you're considering a loan with a teaser rate, be sure to ask what the actual rate will be after the teaser rate expires.

## Home equity lines of credit

Home equity lines of credit are revolving lines, much like credit cards. They almost always carry variable interest rates. The lender sets a limit and allows you to borrow by writing checks up to that amount. Any amount you borrow reduces the amount available until you pay it back. Once an amount is repaid, you can borrow it again.

You'll have several payment options, but remember that the longer you take to repay, the more it will cost.

## To pay for college or other major

expenses. You can borrow against home equity to pay for major expenses, such as college costs for your kids, as long as the payments will fit into your monthly budget. Borrowing can make these expenses more manageable by spreading them out, rather than struggling to come up with a one-time cash payment.

## **USING HOME EQUITY WISELY**

Home equity borrowing may be easier and cheaper than other forms of credit, but it's not a license to spend freely. If you're tapping into home equity for daily expenses or

to make impulse purchases, you're probably not using it wisely.

Now that you know when not to use home equity, here are a few times when it might make sense:

## To make home improvements.

Many homeowners borrow against equity to make improvements to their property. This can be an excellent investment, since improvements can increase the value of your home and result in more equity. Some improvements are more valuable than others, though. You may want to research the housing market

## **CAUTION: HIGH-LTV LOANS AHEAD**

It's possible to take out what's called a high loan-to-value, or high-LTV loan, which lets you borrow more than your home is worth: usually 125% of equity. These loans are positioned as home equity loans, but the amount above your equity is actually unsecured credit.

The danger is, if you sell your home or move, you'll need to come up with the difference to repay your debt. For example, if your home is worth \$200,000 and your home-secured debt is \$250,000, you'll need \$50,000 to pay it off when you sell your home. You may get lucky if your home's value has appreciated, but you can't count on it. Furthermore, the interest on the unsecured portion usually isn't tax-deductible, and rates are higher than for ordinary home equity loans.

## **Credit Cards**

The way you use plastic could make or break your credit.

Credit cards are the credit of choice for everyday financial transactions. They're convenient, and easy to use—but also easy to misuse. If you pick the right card and use it carefully, it can help you build a good credit record that will let you do more of what you want to do financially.

Credit cards are a form of **revolving credit**, which means you can borrow amounts up to your **credit limit**, and any amount you pay back is available to borrow again. Unlike loans, cards have flexible payment schedules. When you get your bill, you can pay your whole balance, the minimum, or any amount in between. Remember, though, that the longer you take to pay, the more credit costs you.

### FINDING BALANCE

In a single month, you could send your balance up and down with purchases and payments. So how do card issuers compute your balance and finance charges? There are three basic ways. You can find which one your card uses by looking at the **method for computing the balance for purchases** in the terms and conditions.

**Adjusted balance** favors cardholders most. It takes your previous balance, subtracts payments, and adds charges.

Average daily balance is most common. It tracks your balance for every day in the billing period and finds the average. Try to avoid cards that use a **two-cycle** average, which is based on two months of balances. It could result in finance charges even if you paid in full the previous month.

**Previous balance** simply uses your previous month's balance, regardless of whether you've made payments. This method usually results in the highest finance charges overall.

### ALL IN THE TIMING

You can enjoy zero interest if your card offers a **grace period**—a free period between the time you're billed for a purchase and when the card issuer begins charging interest, generally between 20 and 30 days. If you pay in full



within that period, no finance charges are added on the next bill. To qualify each month, your previous balance must be paid in full on time. If you don't qualify, finance charges begin as soon as you use the card.

For example, say your card had a zero balance. Then this month, you charge \$100 to the card. If you have a grace period of 20 days, you can pay \$100 by day 20 and owe no finance charges. If you take longer than 20 days to pay in full, finance charges begin on your outstanding balance and all purchases before the next billing date.

### THE RATE OF CHANGE

Changes to the interest rate your card issuer charges you can be triggered by specific events.

**Teaser rates** are low introductory rates designed to attract business. The rates rise to normal levels after a set period.

Promotional rates are like sales on credit—low rates for a limited time, to encourage you to charge more.

Default rates are extremely high rates applied to accounts that have had late payments. Cards with universal default clauses will apply the default rate if you've been late with any payments for any account, even if you've always been on time with that specific card.

## **HOW CREDIT CARDS WORK**



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- 1.You make a purchase by presenting your card or providing your account number and expiration date
- 2.The merchant gets approval to charge the amount to your card by sending an electronic query to the card network, such as Visa®\*

MasterCard®\*\*

3. You sign the receipt or say you authorize the purchase and agree to pay the charge

4.The merchant deposits the receipt in its bank, which sends the transaction to the credit network

5.The credit network processes the transaction and notifies your card issuer 6. Your card issuer includes the transaction on your next billing statement

BILLING STATEMEN

## **CARD COSTS**

All credit cards involve finance charges, and there are also several costs that you may or may not incur, depending on the card you use and how you manage your spending. You'll find descriptions of all the fees and charges in your **terms and conditions disclosure**. Not all of the items listed below apply to all cards, so it might pay to shop around for fewer or lower fees.

**Annual fees** are like membership fees assessed once a year. You can often find cards with no annual fees if you shop around.

**Over limit fees** are charged if your balance rises above your limit—even if your purchases are approved.

Late payment fees are added if you haven't sent in at least the minimum payment by the due date.

**Cash advance fees** are charged if you use your card to draw cash from an ATM or use the cash advance checks provided by the card issuer. On top of these fees, cash advances usually have higher interest rates than purchases.

**Balance transfer fees** are charged when you transfer other debts to your card, assessed as a percentage of the balance you're transferring.

**Inactivity charges** are charged if you don't use your card at all for a specific time—generally around six months, although some cards penalize you more quickly.

**Currency exchange fees** are assessed as a percentage of any purchase you make in a foreign currency.

PICK A CARD—NOT ANY CARD You carry a balance A low interest rate may be most important to you. You pay off in full each month Look for a generous grace period to make the most of your diligence. You're interested in rewards Compare the cost of an **affinity card** to the benefits it offers, to make absolutely sure it's worth it. You're just starting or rebuilding credit Use **charge cards** and **secured cards** to build good credit habits and history. You don't use your card very much Look for cards with no annual fees and no inactivity penalties. You manage your money electronically Look for easy-to-use, free online services on the company's website.

1-800-555-TREE www.LendingTree.com

## Life Stage: Students



CASE STUDY: ASHLEY, 22\*

Where: Rochester, New York Family status: Single, no children Homeowner: No

Income: \$0 (student)

## **DEBT PROFILE**

Total debt: \$45,000 (includes student loans, car loan, and credit card debt)

Monthly payments: \$350/month Student loan (interest): About \$170/month Class credit isn't the only kind of credit you need.

Auto loan: \$120/month (\$1000 balance

Credit cards: One with \$300 balance remaining

## CREDIT STRATEGIES

Ashley is paying her student loan interest during school so she won't have it rolled into her principal when she graduates. Her approach to cutting down debt is to finish her car payments, freeing up money to concentrate on paying off her student loans over the next five or six years.

## **FINANCIAL REGRET**

Ashley prefers paying cash and saves credit cards for emergencies. However, being a student without income means that sometimes groceries and gas are classified as emergencies, and she sometimes is forced to use her credit cards to pay for them. She admits those purchases are a poor use of credit and that she'll end up paying more in interest charges, but for now says that's all she can do.

Right now, you're making the transition from being dependent on your parents to being fully dependent on yourself. There are a lot of financial responsibilities you may be facing for the first time, and the choices you make now could affect you for years to come.



## **GOT YOUR FIRST CREDIT CARD?** Plan to pay in full regularly.

College students are often inundated with credit card offers from lenders who want your business. And why not? Your prospects for employment are good if you've got a college education, and if you sign up for their cards now, there's a good chance you'll stay loyal in your post-college life, when your income and your financial needs are greater.

Credit cards can be dangerous, though, if you don't keep a tight rein on spending. It's way too easy to pull out the plastic instead of buying only when you have the cash. And you have to remember that what you put on a card will cost even more than its price tag if you don't pay for it quickly.

Using credit cards responsibly and paying them off regularly will help you build a good credit record. Good credit will come in handy later, getting you approval for credit applications, qualifying you for higher amounts and lower rates, and aiding your searches for apartments or jobs.

But less responsible credit card use can work against you for a long time, in two ways. First, your credit rating will suffer, hurting your ability to qualify for credit in the future. Second, you'll be starting out your financial life in the hole, which will restrict your budget and force you to postpone your other financial goals until you've dug yourself out of debt.

## MANAGING A BUDGET FOR THE FIRST TIME?

## Get in the habit of planning.

No two students have the same financial situations. You may still be dependent on an allowance from your parents, you may be working part-time to support yourself, or you may be living off of your summer wages during the school year. Wherever your money comes from, you'll benefit from learning to manage it wisely.

The foundation of financial well-being is your ability to create a working budget. This

doesn't mean that you have to scrutinize where every penny goes. But it does mean you have to know the difference between needs and wants, so you don't find you've spent your food money—a need—on concert tickets—a want. If there's something you can't afford, you can budget to save for it. Whatever you do, don't start using credit cards to live beyond your means. Instead, budget to do more with what you've got.



## TAKING OUT AND MANAGING STUDENT LOANS?

Plan to pay in a way that benefits you.

Taking a student loan is one of those times that it's smart to go into debt,

both because college is a valuable experience that will help you immensely in life, and because student loans, especially those backed by the federal government, are usually a

bargain. Rates tend to be low, and repayment terms are flexible. (One caution: Those advantages may not apply to other loans you take to help pay for education.)

Subsidized Stafford loans, which are needbased, are particularly generous, since you aren't responsible for interest that accumulates on the loan until six months after you're out of school, when you start repaying. Until then, the government pays the interest. Unsubsidized

Stafford loans aren't need-based, and interest starts adding up right away.

Because you owe interest from the time you borrow the money, you can choose either to make interest-only payments from the start or to let the interest accumulate until you start regular loan payments six months after you're out of school. If you don't pay the interest now, it will be added to your principal later. It's not disastrous, but it does mean you'll pay interest on interest, making the loan more expensive.



<sup>\*</sup>Case studies are fictional composites that have been compiled from information given by real-life subjects. Each is meant to represent a hypothetical personal credit situation, not any one particular person's situation.

## Life Stage: Singles



CASE STUDY: JEFF, 29\*

Where: Washington, D.C. Family status: Single, no children

Homeowner: Yes Income: \$50,000

There's a lot to love about doing it all on your own.

## **DEBT PROFILE**

Total debt: \$152,000

Credit cards: Pays off his balance each month

**Mortgage principal balance**: About \$126,000. He has refinanced twice, most recently with an ARM at 4.5%.

Home equity line: About \$26,000

## **FINANCIAL PRIORITIES**

- Graduate school
- Retirement
- Paying off home equity line

## **CREDIT STRATEGIES**

Jeff consolidated his car loan and student loans into the home equity line of credit. He also aims to live within his means to avoid accumulating more debt.

## **SMARTEST FINANCIAL MOVE**

Buying a house. Jeff plans to use the equity he's built in his home, as well as its appreciation, to help pay for much of graduate school.

When you're making it on your own, no one else can tell you how to spend your money. The great part is that you're free to make your own choices. The not-so-great part is that you've got just your own income to do it all with. Yet with wise budgeting, credit management, and planning, you can find ways both to make ends meet and to accomplish bigger goals.

## PLANNING A BIG PURCHASE? Start saving and investing.

It could be anything with a big price tag: a down payment for a home, a car, a trip abroad, more education—even your own wedding. Whatever

your own wedding. Whatever you're planning for, if you know how much time you have, you can work out a schedule to set aside a certain amount each month until you've got what you need.

For short-term goals you want to accomplish in the next few years, you can use a savings account, where your cash earns interest, making each dollar you put away worth

Short-term Long-term INVESTING
on work tain e got what

more when you use it later. For long-term goals, such as a comfortable retirement—something that ought to be on your radar screen—you might look for smart ways to invest.

## USING CREDIT TO GET THE THINGS YOU WANT?

## Know the difference between smart and dumb debt.

It can be tempting for you to try to keep up with your well-heeled peers even if it means living beyond your means. But that's a dangerous trap. When you rack up dumb debts with credit purchases engineered for instant gratification, you hurt your future ability to use smart borrowing, such as a mortgage, to get things that can improve your quality of life in much more important ways. Before you borrow, plan the way you'll repay, and ask yourself if the benefit of buying today on credit is worth what it'll cost you in fees and charges tomorrow.

DEBT

Come up with a strategy, and stick to it.

If you've got a lot of high-interest debt, such

PAYING DOWN YOUR DEBTS?

If you've got a lot of high-interest debt, such as credit card balances, you'll have less money available for the things you want. So unless you're confident you can win the lottery, the best way to improve your finances is to focus on reducing your high-interest debt as quickly as possible.

There are two big strategies you can use to get existing high-interest debt under control: consolidate and accelerate. You can consolidate by paying off old debts with a lower-interest loan. It can help fit the payments into your budget, and pay off your debt in a shorter time and with limited

costs. You can accelerate by paying as much over the minimum every month as you can comfortably fit into your budget.

To make your debt reduction plan easier to stick to, consider setting

up an automatic bill payment with your bank or the lender, to draw the money from your account as soon as you're paid, so you can't spend it.

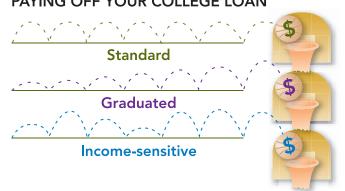
Most important, take care not to accumulate new debt while you're paying off the old debt. You want to break the debt cycle and start investing and saving for the things you need and want.

real-life subjects. Each is meant to represent a hypothetical personal credit situation, not any one particular person's situation.

PAYING OFF YOUR COLLEGE LOAN

\*Case studies are fictional composites that have

been compiled from information given by



## GOT COLLEGE LOANS? Pay down smart debt slowly but surely.

College loans are a great example of smart debt. At the same time, the way you repay affects your credit history, so you need to make smart choices. For federal Stafford loans, you have three repayment options:

- Standard, with fixed payments throughout the term
- Graduated, with low initial payments that rise over time
- Income-sensitive, with payments calculated as a percentage of your income

You want a repayment plan that fits your budget and doesn't cost more than it has to.

You might be attracted by the longest term and lowest monthly payments you can get, but it means your total cost will be higher. Plus, do you want to be paying for college 30 years after graduation?

If your interest rate is low, however, it might be a good idea to put your extra money toward other goals, instead of using it to accelerate your loan payments. Your revolving credit balances have a greater effect on your credit score than a student loan balance does, so it's more important to get rid of those first.

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## Life Stage: Young Families



New obligations plus old equals a lot of bills to pay.

## CASE STUDY: REBECCA, 29, AND **PAUL, 31\***

Where: Monroe, North Carolina

Family status: Married, with a 2-year old child

and a newborn Homeowners: Yes

Income: \$73,000 combined

## **DEBT PROFILE**

**Total debt**: \$129,500

Credit cards: \$6,500 balance on three cards Much of the credit card debt is from their

wedding four years ago.

Mortgage principal balance: About \$100,000 Auto loans: About \$5,000 on one car, and a

lease on a second car Student loans: About \$18,000

## FINANCIAL PRIORITIES

- Paying off credit cards and student loans
- Saving for children's college
- Retirement

## **CREDIT STRATEGIES**

Rebecca and Paul started out with significant monthly payments from their student loans, so their strategy now is to minimize their monthly payments. They leased both cars at first, though last year, when Rebecca's lease was up, she decided to buy her car, financing the \$8,000 cost over three years. Now with two children, their tight budget requires that they continue focusing on low monthly payments, even though they know they'll end up paying more overall.

## **SMARTEST FINANCIAL MOVE**

Rebecca and Paul's first financial priority after getting married was saving to buy a home, and focusing on building equity. They are hoping that growth in the Charlotte area will lift the value of their home over the next few years, too.

A new home, a new car, a new baby on the way—sound familiar? With so many new obligations to plan for and so many old obligations to tie up, you need to get a handle on your credit strategy.

## HAVING CHILDREN?

## Save, and use credit wisely.

What children add to your life is priceless, but the cost of raising them is notoriously high. Not only do you have to think about the costs of feeding, housing, clothing, and getting healthcare for a new baby, but you have to plan to pay later for education, for entertainment, and so on, until your child becomes a self-sufficient adult.

> For big-ticket, long-term goals like college, the best strategy is to save and invest early. Give earnings time to

compound, giving each dollar the potential to be worth more and more as the years go by. It will mean less to borrow later.

In the meantime, you should avoid the bad habit of using credit for daily expenses. It's an easy habit to get into, especially if you anticipate a higher income later. But the better you can budget now, the more you'll enjoy your raise when you get it. (If it never comes, or comes later than expected, you're better off not betting on it now.) Instead, use credit only when you can budget to repay, and when the value of what you get is worth the cost.

\*Case studies are fictional composites that have been compiled from information given by real-life subjects. Each is meant to represent a hypothetical

## **BUYING OR IMPROVING A** HOME?

## Make the most out of homesecured debt.

When buying a home, it's important to shop around and compare competitive offers from lenders before you commit.

You should also consider how long you plan on staying in the home. Many families trade up after a few years, when they can



afford it. That's a better plan than taking on more debt than you can handle now. Be especially careful when considering interestonly mortgages, which have attractive low payments initially but will hit you with higher payments later.

Smart homeowners aim for mortgages that help them build equity. You want your home to be a valuable asset, not a massive liability.

Once you do have equity, you can use it to your advantage through home equity loans and lines of credit. Just remember that you should only take home-secured credit for a good reason—and when you can pay it back.

## PAYING OFF EXISTING DEBT? Prioritize and plan.

It's normal to have debts left over from your single life, such as student loans, credit card debts, and car loans. Getting rid of those debts is an important step toward focusing your financial efforts on your family's

High-interest debts should be the first ones you pay off. Consolidating at a lower rate, such as with a home equity loan, is a good idea. Take care that you don't use a lower rate as an excuse to pay even more

slowly, or worse, to rack up more debt.

## **PLANNING FOR RETIREMENT?**

## Look for employersponsored plans and tax breaks.

The last thing you're probably thinking of is retirement. It can seem so far away. But one reason you have to be careful with credit now is that you don't want to retire in the red, when you can least afford it.

For retirement, as with all long-term goals, it's best to start putting a little bit away early on, especially if you have an employer plan or a way to invest with tax advantages, such as an IRA. Speak to a tax adviser or financial planner about the best way to reach both long-term and short-term goals—without feeling like you can't enjoy today.

## **BUYING A CAR?** Get the most for your dollar.

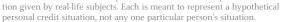
The irony of buying a car is that it's immediately worth less once you drive it off the lot. Cars usually lose about 60% of their value after four years. So you shouldn't spend more than you have to on your car, and you should do your research to be sure the vehicle isn't a lemon—and will have a decent resale value if you need to trade up.

If rates are rising, consider getting preapproval for a loan to lock in a low rate. If rates are falling, consider adjustable or variable rates. You might even finance your car with a home equity loan—which could be the cheapest way.

Be wary of arrangements that

lower your payments by extending the life of the loan. You don't want to pay for your car longer than you'll be driving it. You could

find yourself upside-down on the loan, which means you owe more on your car than you could sell it for-not good.



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## Life Stage: Maturing Families



Your kids are older, but then so are you.

daughters—including braces, sports equipment, and clothing.

Mortgage principal balance: About

\$105,000

Auto loans: About \$6,000

## **FINANCIAL PRIORITIES**

- Buying a car for 15-year-old daughter
- Paying down credit cards
- Saving for college
- Retirement

## **CREDIT STRATEGIES**

Linda and David's house has appreciated significantly in a hot Seattle market. They hope prices stay high so they can downsize when their oldest daughter goes to college, using the extra equity from price appreciation to pay college expenses, since their tight budget leaves little room to save for college.

## **FINANCIAL REGRET**

Withdrawing money from a 401(k) when they fell behind paying their bills.

## CASE STUDY: LINDA, 45, AND DAVID, 46\*

Where: Seattle, Washington

Family status: Married, two teenagers

Homeowners: Yes Income: \$85,000

## DEBT PROFILE

**Total debt**: \$165,500

Credit cards: \$3,500 total on three cards
The majority of their credit card debt
comes from supporting their two

Over time, your finances have been slowly changing. By now, your income may be higher, you may have substantial home equity, and your family may be larger—maybe big enough to merit a bigger house and a roomier car to fit them in. Some of your kids may even be ready to drive cars of their own. You may be getting closer to the day when you'll send them to college.

But your life's not all about your kids. You've got yourself to think about, and possibly aging parents, too. With all these responsibilities, you may be tempted to use credit to improve your quality of life beyond what you could afford to pay with cash. But as in every stage of life, you're better off saving when you can and using credit only when it's smart. You'll thank yourself later, when you're retired and enjoying the freedom that comes with good planning.

## COLLEGE OR RETIREMENT APPROACHING?

## Make the shift to short-term planning.

Things you've been thinking of as long-term goals are coming into short-term focus. It's time to check your progress and ask if you're on track to have what you'll need. You might need to tighten your belt to put more money away.

Most college students borrow some money for school, and there are many ways to do it, such as federally guaranteed loans and home equity borrowing. It's best to avoid borrowing against retirement accounts to pay for college, though. Students can get scholarships—but retired people can't.

With so many complex issues to address, now may be the perfect time to meet with a financial planner, to see if you're making the most of your resources. And as difficult as it is, it may be time to start talking to your parents about the legacy they'd like to leave, and the kinds of arrangements they want you to make for them in their old age.



## GOT HOME EQUITY?

Use it wisely.

Your home equity may be your most important financial resource. But be careful to plan carefully before you borrow against it. One smart choice is to use home equity to pay for home improvements—such as additions to accommodate your family's growing needs—or for college tuition, since it's generally the cheapest way to borrow. And while it will likely get you a lower rate and tax advantages, be careful when using home equity for debt consolidation or for a car. If you overextend yourself and can't pay, you risk losing your home.

## IS YOUR MORTGAGE OUT OF STEP WITH YOUR LIFE? Consider refinancing.

There are a couple of reasons you might refinance. Rates might have dropped, giving you a chance to lower your finance charge. Or you may want lower monthly payments to allow you to stay within your budget.

Refinancing makes sense if you truly can save money, or if the added costs and longer term that come with lower payments can help you achieve important things now. It's not a decision to be rushed, no matter how attractive the terms you're offered. Most important, be sure the benefits outweigh the cost.

Most experts agree that a bad reason to refinance is to tap some of your equity for everyday expenses. It's usually not wise to take cash out when refinancing, unless you're using it for college tuition, home improvements, or another valuable asset.

## BUYING A SECOND HOME? Get the best deal on that mortgage.

The plus side of buying a second home is having a place you love. The minus side is having to cover the cost. But if you can afford it, finding a home in an area with rising real estate values may even be a wise investment.

If you're still paying off a first mortgage, it's likely your second home mortgage will have a higher interest rate, since much of your income is already committed. One suggestion is to use a new mortgage for both homes, but apply for a shorter term to lower your rate and get out of

debt earlier.

## NEED A VACATION?

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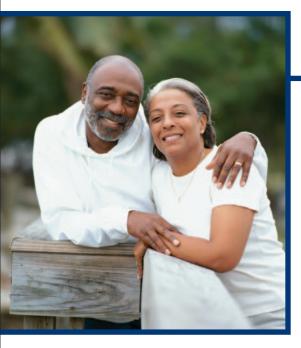
## Have more fun by planning wisely.

Life's not all about mortgages, car loans, and college tuition. Your family needs to have some fun. To make vacations possible, your best plan is to save in advance, making fun a regular part of your budget.

You'll enjoy your vacations more if you know everything is paid for, rather than worrying the whole time about whether you can afford it. When you do use credit on vacation, it's extremely important not to get carried away. Credit card bills make bad souvenirs.

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## Life Stage: Empty Nesters



## CASE STUDY: ROBERT, 63, AND JUDY, 62\*

Where: Kirkwood, Missouri

Family status: Married, three college-age

children

Homeowners: Yes

Income: About \$155,000 (includes Judy's

pension)

## **DEBT PROFILE**

Total debt: About \$276,000

Credit cards: \$0 balance on two cards
Mortgage principal balance: \$200,000

There's still plenty to plan for after the kids have flown the coop.

Home equity line balance: \$39,000

Auto loan: \$25,000 Student loans: \$13,000

## **FINANCIAL PRIORITIES**

- Paying off children's student loans
- Retirement
- Second home

## **CREDIT STRATEGIES**

Robert and Judy downsized a few years ago and took out a home equity line of credit at historically low rates to renovate their house. Earlier this year they drew on the line again to pay for their daughter's wedding. With short-term interest rates rising, Robert is planning to refinance and roll the home equity line into their mortgage, while locking in a lower interest rate. They don't have a plan to reduce their debt. Though Robert is still working, both have solid pension plans that will allow them to continue to pay off their loans in retirement.

## **FINANCIAL REGRET**

Not applying for financial aid to pay for college for their children. Because Robert and Judy had high incomes and had saved a fair amount, they didn't think their children would qualify. But when their third child was in college, they decided to apply—and qualified for a small grant and a low-interest loan.

For so long, your children have been a top financial priority, commanding much of your time, money, and mental energy. Now that they've moved out, the house may seem larger than you ever imagined. While you still may be offering your children some financial support, your attention needs to turn to other priorities. It's probably been years since you've made plans just for yourself, so you'll need to make some adjustments.



## STILL HELPING OUT YOUR CHILDREN?

Keep liquid savings on hand.

Often, parents find they're supporting grown children in little ways, such as cash gifts here and there to help until they're self-sufficient, and big ways, such as paying for weddings and college loans. If you know your children will still need some ongoing financial support, it might be a good idea to take a percentage of the money you used to spend on your children and set it aside for those times you'll have to help them out again.



## PAYING OFF COLLEGE LOANS? Choose the repayment plan that fits.

Parents who take PLUS loans, the federally sponsored education loan for parents, have the same kinds of options that students do for repayment plans. You can choose one of the following:

- Standard, for fixed payments throughout the term
- Graduated, for payments that start low and gradually rise
- Income-sensitive, for payments based on your actual income
- Extended, letting you pay off over a longer timeframe
- Consolidated, to simplify multiple loans into one

Unlike student plans, however, you start repaying PLUS loans as soon as you borrow. If you can afford it, a faster repayment schedule with the standard option will get you out of debt faster and result in lower interest payments. The graduated option is probably the worst choice if the loan term extends into your retirement, since payments will be highest when you're living on a fixed income.

## SUPPORTING YOUR PARENTS? Take responsibility

for financial planning. You may find yourself lending support to both your older children and your parents simultane-

ously. In fact, there's a term for people in your circumstances: the sandwich generation. Several trends—having kids later in life, kids living longer at home, and people living longer—have made the situation extremely common. The timing is particularly tricky, since

usually these obligations must be met while you're trying to plan for your own retirement.

It's important to work with your parents as much as you can to understand what their financial resources are, and what they want and expect from you. These conversations can be difficult, but it's better to be prepared than be surprised if it turns out your parents need more financial support from you than you anticipated. Plus, having adequate emergency savings is critical at every stage of life, but especially so when others depend on you. The rainy day you're saving for may never come, but if it does, you won't get soaked.



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## HOME FEEL TOO LARGE? Consider scaling down.

There are sentimental reasons to keep the house your children grew up in, but there are practical reasons not to. For starters, a big house may be exhausting to maintain. If it's highly valuable, the property taxes may be an unnecessary drag on your budget. And if you've got lots of home equity built up in it, you could sell it to a growing family that can use the space and move to a smaller, less expensive house—or one you've had your eye on for years but wasn't practical before. That frees up the difference in equity for other uses, like building your retirement nest egg.

## Life Stage: Seniors



CASE STUDY: MARY, 67, AND HAROLD, 72\*

Where: Orlando, Florida

Family status: Married, three adult children

Homeowners: Yes

**Income**: About \$75,000 annually

**DEBT PROFILE** 

**Total debt**: \$168,000 Credit cards: About \$4,000

Mary and her husband have cut back to using just one credit card, which they pay off

With planning, you can enjoy what you've earned.

in full each month, and are paying off the balances on the rest of their cards.

Mortgage principal balance: About \$140,000 They refinanced their home a few years ago and locked in a lower rate. They also took cash from their home's appreciation to build a mountain house, which they sold before completing it because the maintenance and travel got to be too much.

Car loan: About \$24,000 They have about four years left on the five-year loan.

## FINANCIAL PRIORITIES

 Becoming completely debt-free (including) paying off their house)

### CREDIT STRATEGIES

- Pav more than the minimum due on their credit cards
- No new debt
- Moving away from supporting their children financially

## **FINANCIAL REGRET**

Taking cash out when refinancing their mortgage. The refinancing extended the time it will take to pay off their mortgage completely, and they never got to enjoy the second home because of the distance from their primary home.

Retirement may be something you've been looking forward to for decades—or that's turning out to be fun despite your reservations. Now that you finally have time to do everything you want to do, managing your money is extremely important. Most seniors find themselves living on fixed incomes—from pensions, investments, and Social Security benefits—for much longer than previous generations did, thanks to medical advances and longer life spans.

Certain costs, such as what you spend for clothes and daily transportation, tend to go down, but others, such as your healthcare costs, tend to go up. You can make the most of your retirement by making the most of the financial resources you've built up over the years.

## **GOT A LOT OF HOME EQUITY?** Find smart ways to use it.

Seniors may find themselves in the curious position of having little cash but owning a very valuable home. This can make your home one of your most important financial resources—and a good reason to focus on building home equity in your working years, and not borrowing against it for casual expenses.

There are a number of ways to use the equity you've built up to help boost your income now.



Home equity loans and lines of credit are two methods you're probably familiar with, but they may not be your best bet now. You would have to squeeze the loan payments into your budget, and the interest rates may be high because of your limited retirement income.

What's more, if you're using home equity for living expenses, there's the risk that you'll eventually run out of equity to use. However, if rates are low and there are inexpensive opportunities available, you might consider borrowing against your home equity to make investments that could earn more than you'd be paying in interest and fees. It's a more

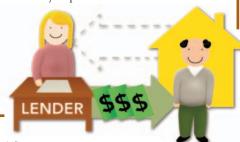
sophisticated and riskier use of your equity, however, and best done only by already confident, knowledgeable investors. Make sure you talk with a professional financial adviser.

**Reverse mortgages** are a type of home borrowing designed to let you turn your home equity into cash. But instead of borrowing and repaying, as you would with a home equity loan or line of credit, you receive regular payments from the lender without making loan payments in return. The loan is repaid when you either die or sell the home. As long as you're living there, you won't have to repay.

Before you decide that a reverse mortgage is right for you, note that the costs of arranging a reverse mortgage are often high, and frequently the amount you can borrow is significantly less than the home's value. But if you plan on living in your home for the rest of your life, this type of loan may be worth considering. Consult a financial adviser before making a decision.

If you qualify, you can generally borrow the highest amounts with a Home Equity Conversion Mortgage (HECM), which is insured by the federal government. It's not cheap, but it does tend to provide higher amounts and is usually the least expensive option offered by private lenders. The least expensive reverse mortgages overall tend to be those offered by state and local governments.

The other way to use your home equity is the simplest: sell your home and move to a less expensive one. The difference between your proceeds from the sale and the cost of your new home is yours to save, spend, or invest as you please.



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Look for smart solutions before falling into debt.

Sometimes seniors find themselves in a financial pickle. Frequently, the income you receive is fixed, but your costs rise every year with inflation. The longer you live, the more

expensive everyday living becomes. In addition, healthcare may become a bigger and bigger portion of your budget, and healthcare costs are rising faster than other costs these days.

Therefore, budgeting and planning are just as important, if not more so, when you're retired as they were when you were working. You should continue saving and investing for the things you want—vacations, second homes, hobbies, and being generous to your children or grandchildren.

Remember, the temptation to use credit cards to fund your purchases may be more dangerous now than it was before you retired. You don't want to find yourself paying interest on yesterday's spending or having to ask your children to bail you out of a financial jam.

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### **GLOSSARY**

### Amortization

The gradual reduction of a debt through regular, monthly payments of principal and interest, paid for a predetermined time.

## Annual percentage rate (APR)

The annual cost of a loan to a borrower, expressed as a percentage of the loan amount. It includes interest plus other charges or fees. The Federal Truth in Lending Act requires that every consumer loan agreement disclose the APR in large, bold print. Borrowers can use the APR as a basis for comparing the cost of loans.

## Closing costs

Includes a loan origination fee, points, appraisal fee, title search and insurance, survey, taxes, deed recording fee, credit report charge, and other costs assessed at settlement. The closing costs usually are about 2% to 6% of the mortgage amount.

## Compound interest

Interest computed on the principal balance of a loan plus accrued interest.

## Credit report

Report of an individual's credit history that a credit reporting company or credit repository prepares to determine a borrower's creditworthiness.

### Credit score

Number generated by a statistical system used to rate credit applicants according to various characteristics relevant to creditworthiness.

## Debt consolidation

Method of combining several debt accounts by transferring the balances to a single loan or line of credit.

## Finance charge

The total dollar amount credit will cost.

## Line of credit

A type of revolving credit account that allows you to borrow against a preset credit limit amount. Interest is charged only on the amount borrowed. As you repay the balance, the amount repaid becomes available to borrow again.

### Loan-to-value (LTV) ratio

The relationship between the amount of the mortgage loan and the appraised value of the property expressed as a percentage. For example, if you borrow \$150,000 on a \$200,000 property, your LTV is 75% (the loan is 75% of the property's value).

### **Points**

Up-front additional payment you may be able to pay at closing to lower the interest rate on your loan. Each point is equal to 1% of the loan amount (e.g., two points on a \$100,000 mortgage would cost \$2,000). Also called discount points.

## Preapproved loan

A loan the lender issues to the borrower before buying. These loans are usually valid for a limited time, such as 30 days from the loan approval date.

## Prepayment penalty

Money charged for an early repayment of debt. Prepayment penalties are allowed in some form (but not necessarily imposed) in 36 states and the District of Columbia.

## Prequalification

Occurs when a lender estimates what size loan, usually a mortgage, you can afford. A prequalification estimate is non-binding, unlike preapproval, which is an actual agreement to make the loan.

## Prime rate

The interest rate charged by lenders to their best, most creditworthy customers. Borrowing at below-prime also occurs, but is less common and usually applies to businesses, not individual consumers. Many consumer loans are based upon the prime rate.

## Revolving debt

Debt that typically has a variable interest rate, an open-ended term, and payments that are based on a percentage of the balance. The debt has a set limit agreed upon by the lender and borrower

### Secured debt

Money borrowed that is guaranteed (or secured) by the borrower's funds or assets and held by the lender in an interest-bearing account. Distinguished from unsecured debt.

## Simple interest

Interest that is paid on the principal amount borrowed. Considered the best interest term for a borrower because it is not compounded.

### Subprime loan

A loan offered to people who do not qualify for a conventional loan, either because of low income, a high loan-to-value ratio, or poor credit history. Generally carries a higher interest rate than a conventional loan.

## Unsecured debt

Debt without collateral to back the loan in case of default. Generally carries a higher interest rate than secured debt.

### Upside-down loan

A loan secured by collateral that has depreciated in market value and is worth less than the balance owed.