ON THE MONEY

THE NEW RULES of BORROWING

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Over the last decade, Americans have been able to access credit too easily. Being able to borrow too much allowed many of us to make bad decisions – decisions that led to painful consequences. Now, the business of lending has changed and the rules of borrowing have changed as well – some, for the better. That is why it is more important than ever to understand how borrowing really works. From good debt to bad debt, from credit cards to credit scores, learn how to make credit do what it is supposed to – work for you!

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WORKSHEET 3-1: GOOD DEBT VS. BAD DEBT

Debt can be a very powerful tool when it is used to build personal wealth. For instance, a low fixed-rate student loan is what we call good debt. Student loan debt is an investment in you and your future and will most likely lead to substantially higher earnings. When debt does not build net worth and is the result of poor spending and budgeting habits – say a flat-screen TV you cannot afford – it's bad debt. Bad debt doesn't build wealth or our earning power – it just saps our financial strength. Take a moment to answer a few simple True or False questions to see how much you know about the difference between good debt and bad debt.

TRUE OR FALSE

_____ **1.** If I'm taking on debt for a good reason, then it must be "good" debt. "Bad" debt usually occurs when I'm overspending for the wrong reasons.

_____ **2.** An investment in your financial future, such as a college loan, is an example of "good" debt.

_____ **3.** A 30-year fixed-rate mortgage is an example of "good" debt.

_____ **4.** An adjustable-rate mortgage is a good investment tool, hence "good" debt that helps you beat the system.

_____ **5.** Private student loans are high-interest loans for which you must begin paying the interest right away, these can be "bad" debt.

_____ **6.** A public student loan has a variable-interest rate and strict pay-back terms, and is therefore a kind of "bad" debt.

_____ **7.** When you're underwater on a loan it's because you owe more on that loan than the investment is worth. This is "bad" debt.

List three examples of good debt that you may have:

____

____

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List three examples of bad debt that you may have:

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Review your answers to the True/False quiz with the key below:

1. **False.** Debt taken on for what you think is a good reason isn't necessarily equal to good debt. Many of us have taken out loans that didn't make sense simply because they were available to us, not because they were helping us use debt in the correct way. The best ways to evaluate good and bad debt are to make sure you can afford to take it on, research and secure the best terms for yourself, and be sure that there are no better alternative ways to achieve the same result without taking out that loan.

2. **True.** Generally speaking, an investment in your future is an example of good debt, but even debt that is theoretically good, can be bad if you don't seek out the right type of loan. Read below to find more details on student loans and the differences between them.

3. **True.** A 30-year fixed mortgage is a great option for those of you looking to buy a home and obtain a mortgage. Locking in your interest rate is smart because you'll know what to expect and that you can comfortably afford your home for the life of your loan.

4. **False.** I'm not a fan of adjustable mortgages. There's just too much uncertainty and they've allowed people to buy too much house. When interest rates are at, below or around 7%, you're always better locking in a good rate for 30 years.

5. **True.** Private student loans should be taken out as a last resort. I recommend exhausting all other options before taking these loans out to finance your education. For example: federal loans, scholarships and state-funded education programs are great as opposed to private loans with high rates and terms that might not be the most favorable for you. However, private loans don't have to be bad debt if you manage them well and they can increase your earning potential.

6. **False.** When it comes to borrowing for school, federal student aid is the best option. If the government is willing to lend and if you qualify, you should take advantage of these low interest rate loans with favorable terms.

7. **True.** When you're "underwater" on a loan it's because you owe more on that loan than the investment is worth. Many people fell underwater on their mortgages this past year when housing prices plummeted.

For more information on saving for college, student loans, financial aid and scholarships, go to finaid.org.

Good debt is an investment in yourself, in your future, and in your productivity. Good debt will help build your net wealth over a long period. Bad debt does none of that. Bad debt allows you to charge your "wants" not your "needs." These are usually depreciating assets – i.e., unnecessary luxury items or loans that don't offer favorable terms. Bad debt shakes your financial foundation, while good debt helps you build one.

WORKSHEET 3-2: DIGGING OUT OF DEBT

If you're digging out of debt, you're far from alone. Take comfort in the fact that there is no shame when it comes to being in debt, but that it is always a good idea to begin working off that debt as soon as you can. To do that, put a plan in place that helps you define your goals. There is no doubt that this will take hard work and discipline, but you'll free up money that can be better used to build a prosperous financial life.

Spend a minute on this quiz to review some ways to dig out of debt. Even if you're not in debt right now, this quiz will highlight some important tips that will help keep you debt free.

1. When dealing with large amounts of debt, my rights with regard to credit card companies are _____.

- **A.** numerous
- **B.** equally divided between the credit card companies and me
- **C.** are virtually non-existent

2. The following are good examples of trying to find more money to pay off debt, except _____.

- **A.** a second job
- **B.** applying for another credit card
- **C.** cutting unnecessary expenses

3. When paying off multiple credit card bills, you should rank them and pay them in order of _____, and pay off the card at the top of the list in full first.

- **A.** lowest-to-highest annual percentage rate (APR)
- **B.** highest-to-lowest APR
- **C.** largest balance

4. You should _____ your other credit card debts while attempting to pay off the card at the top of that list.

- **A.** not pay
- **B.** pay an equal amount toward
- **C.** pay the minimum required amount toward

5. When dealing with unmanageable credit card debt, your first order of business should be to _____.

- **A.** organize your bills and contact the lenders
- **B.** apply for bankruptcy
- **C.** ignore it, and like any problem, it will go away

6. Working with a credit card counseling service is _____.

- **A.** never helpful, they're mostly scams
- **B.** a good idea if they are a legitimate company
- **C.** only delays the inevitable

7. Credit card companies can change your interest rate _____.

- **A.** but they rarely do
- **B.** whenever they feel like it
- **C.** once every calendar year

8. If my credit card company does change my interest rate, they must _____.

A. ask my permission

B. first reach me on the phone

C. give me fifteen days written notice

9. Bankruptcy is _____.

A. a measure of last resort

B. a get out of jail free card

C. always the way to go

10. Chapter 7 bankruptcy is _____.

A. a full-blown proceeding in which the court liquidates all your assets

B. a small proceeding in which you get to keep most of your stuff

C. a repayment plan, approved by the court, where you pay off your debts in three to five years

11. Chapter 13 bankruptcy is _____.

A. a full-blown proceeding in which the court liquidates all your assets

B. a small proceeding in which you get to keep most of your stuff

C. a repayment plan, approved by the court, where you pay off your debts in three to five years

12. Chapter 11 bankruptcy is an option, but one targeted at people who _____.

A. have no assets to collect or income to garnish

B. are married

C. have serious assets or income

Take a moment to review your answers with the key below:

Answer Key: 1-C, 2-B, 3-B, 4-C, 5-A, 6-B, 7-B, 8-C, 9-A, 10-A, 11-C, 12-C

Remember, getting into debt limits your options, drains your ability to build a solid financial life and keeps you from building personal wealth. To get out of debt, knowing the rules and options are key. If you find yourself in a situation where you need more help consider credit counseling, visit nfcc.org to talk to a non-profit credit counselor.

Make a commitment to reduce your debt and then live debt free, even if that means making some difficult budget cuts now. Being in control of your money and in control of your life means living within your means so you can have both peace of mind and financial freedom.

WORKSHEET 3-3: CREDIT SCORES & CREDIT REPORTS

Your credit score is a number you carry with you your whole life – it is like your adult report card. Any time you want a loan or to take on some of that good debt we've mentioned, lenders check into your credit history and credit score to determine how much of a risk you are, i.e. your credit-worthiness. That is why it is important to understand the basics of credit scoring, who constructs your score and how.

Take a minute to play "Which Is Not Like the Other?" Determine which does not belong in a discussion of credit scores and credit reports. Then, answer and explain the connection.

EXERCISE 1

A. FICO
B. Credit Score
C. Fair Isaac Corporation
D. FICA

Which of these answers does not belong? ________

Why? ____

____

EXERCISE 2

A. Equifax
B. Experian
C. Transunion
D. Trans-Pacific

Which of these answers does not belong? ________

Why? ____

____

EXERCISE 3

A. Check annualcreditreport.com
B. Handle everything over the phone with your credit card company.
C. Inform the reporting credit agency in writing within 60 days of getting a copy of your report.
D. Ask the credit agency in writing to send a corrected report to anyone who recently has reviewed it.
E. Be prepared to stay on top of the situation for a long time.

Which of these answers does not belong? ________

Why? ____

Let's review the answers:

EXERCISE 1

The common thread between the terms is that they describe your credit score. "FICO" is a "Credit Score" developed by the "Fair Isaac Corporation." FICO scores are used by many mortgage lenders that use a risk-based system in determining the possibility that the borrower may default on a financial obligation to the mortgage lender.

"FICA" is the term that does not belong.

EXERCISE 2

The common thread between the terms is that they describe the 3 major credit bureaus. "Equifax," "Experian," and "Transunion" are credit bureaus that collect information from various sources and provide consumer credit information on individuals for a variety of uses. These bureaus and their reports help lenders assess credit worthiness, the ability to pay back a loan, and can affect the interest rate and other terms of a loan.

"Trans-Pacific" is the term that does not belong.

EXERCISE 3

The common thread between the terms is that they describe how to check and handle inaccuracies on your credit report. You can pull your report for free once a year only at "annualcreditreport.com." If you notice errors "inform the reporting credit agency in writing within 60 days of getting a copy of your report" then "ask the credit agency in writing to send a corrected report to anyone who recently has reviewed it" then "stay on top of the situation" to make sure the changes were made and the report is accurate.

"Handle everything over the phone with your credit card company" does not belong because that's exactly what you want to avoid doing. Instead, handle credit report issues with the bureaus.

One last note... take your credit score seriously – everyone else does!

WORKSHEET 3-4: MORE ABOUT CREDIT CARDS

Credit cards are tools, but like many tools, they can end up hurting us when not used properly. To make sure you remain in control, you need to know EXACTLY the sort of damage credit cards can inflict. Take time for this True/False quiz to see how much you really know about your plastic.

TRUE OR FALSE

_____ **1.** The average U.S. household carries more than $8,000 in debt.

_____ **2.** In the 1970s, there were about 20 million credit cards in circulation, about thirty years later that number skyrocketed to 1.3 billion.

_____ **3.** Debit cards are the perfect antidote to credit card free-for-alls. Each swipe of a debit card at a grocery store takes money directly from a checking account and at no cost to you.

_____ **4.** If someone steals your debit card and buys a trip to Vegas with it, you can work with your bank to get your money back – but it takes more time than you might have to complete the process.

_____ **5.** In the credit card world, a deadbeat is someone who never pays a bill on time.

_____ **6.** The APR is your adjustable percentage rate or the interest rate your credit card company charges you.

_____ **7.** If you default on one credit card, your other credit card companies will know and could raise your interest rates.

Let's review your answers:

1. True. On average, U.S. households carry about $8,000 in debt and many much higher.

2. True. Between the 1970's and 2000, the number of credit cards in circulation spiked about 6,400%.

3. False. Sorry, but there are fees attached. Usually $1 or $2 per transaction.

4. True. Trust me on this one. It is not a fun experience.

5. False. Actually, it's the opposite. A deadbeat in the eyes of a credit card company is a person who pays their bills, on time and in full, never letting the credit card company make money off interest owed.

6. False. Sorry, had to see if you were paying attention. It's the ANNUAL percentage rate.

7. True. It is called universal default and is one of the perils of dealing with credit card companies.

If you find yourself with a lot of bad debt, budget your way out. And remember, debt and credit cards are tools that if managed properly can work to your advantage. If you're going through this workbook and do not have bad debt – stay out and continue to live a debt-free life. For more tips on smart borrowing, go to onthemoney.cnbc.com.

Congratulations. With the completion of this workbook you've mastered some of The New Rules of Borrowing. If you missed it, go back to Workbook 2 to learn The New Rules of Family Finances. If you're ready to move on, go to Workbook 4 to learn The New Rules of Retirement.