Credit When Credit is Due

by Paul Strassels

This book is dedicated to all those who, on their own and without the benefit of guidance and help, have struggled mightily with their personal finances. All hope that past mistakes will never be repeated by future generations.

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Table of Contents

LESSON ONE

THE FACTS OF LIFE

Welcome to the real world of personal finance and the responsibility that goes with it. Bundle up, because it can be cold and lonely out there when you are on your own.

This chapter provides an overview of credit and debt issues that all adults face. It points out many of the pitfalls and hazards that significantly affect people's lives, either temporarily or permanently.

When it comes to money, life's lessons can be harsh and unforgiving, but they don't have to be. You have choices to make. How well you make those choices will determine whether you live the good life or a life of constant worry. You can have money in savings or you can have serious money problems.

The unfortunate reality is that too many people choose the difficult path. They spend more money than they make. They give in to the urge of impulse buying. They fail to plan for the inevitable emergency. The result is they often find themselves only a couple of paychecks away from the homeless shelter. Rarely does it have to be that way. Most financial problems can be avoided in the first place, or resolved when they do crop up.

Life doesn't have to be gray, like it is for those with constant money worries. Life can and should be bright, colorful and enjoyable.

To have a chance to live a life free of excessive money worries, there are at least 20 areas of personal money management that you need to master.

- Live within your means. Don't spend more than you make. Don't take on more debt than you can afford to repay, even if someone is willing to lend you the money.

- Budget your money. Budgets are not only for older folks or the young. Budgets are for everyone. Period. If you don't use a budget, you're missing the single most important financial tool available to you.

- Anticipate your expenses. You have to know what bills are coming due this month and next, and you have to know how you are going to pay them.

- Save a little every payday and learn how to invest what you save. If you don't see the money, you won't miss it. With savings, you will be able to get through that inevitable emergency. If you don't invest your savings, you won't have much of a nest egg when you need it.

- Understand how credit and debt work, and determine how much debt you can comfortably repay. Credit is the amount of money that is available to you through lenders; debt is simply the amount of credit you are using at any given time. Credit

LESSON TWO

The cold, hard fact is too many people have too much debt and not enough income; consider your own household. A household is defined as an address with somebody living there. It may be a single individual or it could be a family with lots of kids and up to three generations living together. The government says that the average household income is somewhere around $50,000 a year, and that is before taxes are taken out. Can you cover all your bills on what you make? Or do you need more income?

Whatever you earn and whatever your lifestyle, you need enough income to cover your bills. When you have enough money, life is good. When you don't, you worry.

The fact is, too many people don't make enough money to pay their bills, or they make just enough to squeak by, and often that takes two incomes. They are living on the edge, worried about how they will pay their bills. They may wake up in the middle of the night worrying about their jobs, unexpected medical expenses, an upcoming divorce, or just worrying about all sorts of money matters.

They should be concerned. They don't bring home enough money. They have too many expenses. At best, they live paycheck to paycheck. They do not plan their money matters, because, they say, what's to plan? They feel they don't make enough money to do more than get by day to day. When a financial emergency strikes, and eventually it always does, they are overwhelmed. They do not have sufficient savings to see them through a financial crisis. They have nowhere to turn.

When they lose a job, have their work hours cut, the plant closes for two months, there's a strike, someone in the family gets seriously ill, interest rates go up, gasoline prices soar, the car breaks down, the water heater bursts, there's a divorce, one of the kids needs braces, or any of a dozen other common problems, they have precious few options. They are out of money with a mountain of bills and they fail to seek help until they are too deep in debt.

Rob Lost His Job, and He Never Saw it Coming

Consider what happened to Rob. He had just graduated from college and landed a job paying $28,000 a year to start, plus a nice benefit package. It was a business which had been in the community for more than 50 years. Within a week, he found himself at the new car lot, anxious to trade in his "red hunk of junk" which had seen him through the last 4 years of school. The price tag for the new car was $28,000. "What the heck," he thought. "I can afford the $489 a month payment over the next 5 years. I'm working now. I don't have to wait."

He was right about one thing. He could afford the car payment, **as long as he kept his job**. He didn't. He didn't do anything wrong. In fact, he was getting along quite well. He

TO BORROW OR NOT TO BORROW

That is the question. It is a far, far nobler thing you do when you ask yourself before you make a purchase if you really want or need to borrow money to pay for it.

There is an essential lesson to learn in this chapter. **Before you make a purchase, any purchase, large or small, you need to ask yourself if you will pay for it with cash from your wallet, checkbook or savings account, or if you will charge or finance your purchase and pay for it over the next few months or years.** The problem is, too many people fail to consciously ask and then answer the question of “cash or charge.” You need to make it second nature to ask yourself this question before each and every purchase you make, whether it’s chewing gum at the grocery store, a can of soda at work, or a new car at the local dealership.

There Are Two Types of Purchases — the Everyday Variety and The Big Stuff That Doesn't Come Along Very Often

Let’s get the big stuff out of the way first.

Certainly, there are at least 2 items, perhaps 3, that you will probably purchase during your lifetime where you have no choice but to take out loans. They include buying a house, buying a car, and if you choose, attending college. The costs of these items are simply too high for most people to cover with their savings.

Average housing can cost upwards of $200,000 or more, and in some areas of the country, (such as San Francisco) the average home can cost over $700,000. Almost no one has enough money in savings to be able to pay cash for their house. No one expects you to. You will most likely visit with a mortgage lender and arrange for a loan that can take 30 years or more to repay, assuming of course that you have good credit references, a favorable job outlook, and modest bills in relation to your income. (You will find more on mortgages in a later lesson.)

Cars are a different story, but not by much. Some people, but not many, save enough money to pay for their cars. There are fewer and fewer people every year who can manage it now that the average price of a new vehicle is around $35,000. If you’re buying a new car, it’s typical for you to take out a 3 to 5 year loan. Some lenders are even going to 6- or 7-year loans in an effort to keep monthly payments affordable. If you take out a loan for that length of time, make sure you are confident that the vehicle will last as long as your payments. Otherwise, you could be paying for a car that is sitting in the junk yard.

Of course, there’s the option of leasing a car instead of buying it. But the reality is, you’re still making those monthly payments, and you better be able to afford them.

Used vehicles are usually less expensive than new. Still, they can cost tens of thousands of dollars. For used cars, loans will run for a shorter period of time, but you still have to be able to afford the monthly payments.

LESSON FOUR

SO YOU HAVE DECIDED TO BORROW SOME MONEY

What makes you believe that anybody is willing to lend you money? If the tables were turned and you were a lender, would you lend money to someone with your income, your job security, and your debts? Be honest.

In the last lesson, you learned that you have many options when it comes to paying for the things that you may want to buy. You considered whether it's preferable to borrow money or to wait and pay cash for your pur chases. And you learned that saving until you can afford to pay for an item in full may be a better option than using a credit card. You also learned that you can delay paying for a purchase by finding someone who will trust you to repay what you borrow.

While you alone can decide when you are going to buy something and pay cash for it, the decision to buy on credit is a bit more complicated. In order to pay over time, someone has to be willing to extend credit to you. The real question becomes: Who are you going to ask to trust you to repay a loan?

A variety of lenders are eager to lend money to creditworthy borrowers. After all, that's their business. This list includes banks, credit unions, car dealers, finance companies, and credit card issuers, to name just a few. But notice that the key word here is "creditworthy." While all these lenders are in the business of lending money to people, they really are quite choosy. They want to do business with people who they are confident will pay them back. They would rather not lend to those people who will not make their payments in full and on time.

Considering Creditworthiness: Role-Playing

You can take one of two approaches to learn about lending practices-both involve some role-playing. First, try putting yourself in this position: one of your friends, neighbors, relatives, or co-workers asks to borrow some money. In the second instance, put yourself in a lender's shoes and ask yourself if you would lend to someone like yourself.

Let's set the scene for the first case. You can be almost anywhere. You may be doing yard work, taking a walk through the neighborhood, sitting at home eating dinner, or watching television. You could be at your desk at work or spending a few minutes in the break room. You might be at lunch or shopping.

Unexpectedly, your friend, neighbor, colleague, or relative stops by and strikes up a conversation. At first it seems harmless enough. He might remark about the weather, what the boss is wearing, or how some sports team is doing. The conversation is casual at first, but eventually, the subject comes up. **He wants you to lend him some money.**

LESSON FIVE

THE TERMS OF THE DEAL

When it comes to your money, what role should trust play? How do you decide who is trustworthy and who isn't? Television and radio commercials and ads on the Internet and the Yellow Pages are always touting businesses you can trust. But does the word "trust" in an advertisement automatically make an individual or business trustworthy?

Lelah wanted to purchase a sofa at a local furniture store. She could have paid cash for the sofa, but she decided instead to fill out an application for a 12-month, interest-free loan. After her loan was approved, she received a call a couple of days later from a loan officer from the finance company handling the furniture store's loan applications. The loan officer told Lelah that he was reviewing her credit report and found she had great credit. He said that he could save her $100 a month on her mortgage payment.

Should Lelah believe the man on the phone? After all, he was a loan officer. Lelah decided to question the loan officer. She asked what interest rate he was offering and the terms of the loan. The interest rate was 2% higher than her current mortgage. Lelah asked how it was possible that he could save her $100 a month. The loan officer said that perhaps he had made a mistake and would run his numbers again. Sensing that something was not right, Lelah told the loan officer that she was not interested in his offer.

When it comes to your money, you should look for an individual who is knowledgeable in his or her profession. Keep in mind, however, that professional credentials alone do not ensure a person is ethical or trustworthy. Ask the professional for references - reputable professionals are never offended by this question. Don't stop there. Ask your friends and relatives where they have received good service. Credit counselors can give you example after example of individuals who were taken advantage of by prominent business people who claimed to be trustworthy and honest, but their practice was anything but.

Lelah's situation could have had a very different outcome had she not asked questions. The fast-talking loan officer may have convinced her that he could save her money. She would have found that refinancing her home would have raised her house payment, instead of lowering it. If Lelah tried to go back to the loan officer, he would most likely say that Lelah had misunderstood what he said. Reputable business people will put the terms of the deal in writing and will stand behind those terms.

When it comes to your money, choose to work with someone who is knowledgeable, willing to put the terms in writing, and willing to stand behind those terms. You do not want to work with a person who is too busy to put terms in writing, who leaves blank spaces in documents, or who changes the story and the terms every time they talk to you. Do your homework first. Then learn to trust yourself. If something does not seem right, ask more questions until you feel comfortable. If you are still uneasy about the terms of a deal, walk away before you sign any documents.

LESSON SIX

AUTO LOANS AND LEASES

The last time you bought (or leased) a car, did you get a good deal? How do you know? Would the dealership have charged less if you negotiated harder? Was your financing the best you could find? Are you sure?

Do you know all that you need to know about buying or leasing a car? Chances are, you are among the 99 out of 100 who do not. Nevertheless, you will probably still go car shopping, find the make and model that strikes your fancy, and ink the deal even though you know you are terribly unprepared.

Setting up a car deal requires a lot of knowledge, especially as it relates to the terms of your loan or lease. Let's face it. A car is a very big-ticket item, very big indeed. While you probably buy and sell a home only a couple of times between your 20's and 70's, you will, most likely, find yourself at the car lot at least once every 4-5 years, if not more frequently. Today, new car prices average more than $35,000 and used cars are holding their value. The prices on new and used cars continue to go up with no end in sight.

Let the Buyer Beware

Do yourself a favor and review the beginning of Lesson Five where it talks about "Trust." The fact is there is a lot to learn about car deals. The old cliché — **Caveat Emptor, or Let The Buyer Beware** — is as true today as it was when it was first uttered centuries ago, and they didn't have cars back then.

Car dealerships are in the business of selling cars and trucks. Banks, credit unions, finance companies and others make their money by financing the deal. The dealership's finance office wants to help arrange the financing because they get fees and commissions, plus they sell things like warranties and credit insurance. That's how everybody makes money on the deal.

It's your money that pays everyone. So that you don't overpay, you need to spend the time it takes to investigate the make and model that suits your needs as well as the financing terms that work best for you. If you overpay, it's your choice, not the dealership's or the lender's. If you don't ask all the questions about financing, it's your fault again.

For example, Michelle recently bought a car and financed it with her lender where she does all of her banking. She asked what the rate was for a $16,000 car loan over 4 years, and the loan officer told her. The rate seemed competitive with what she had heard, so she accepted the deal. Two months later, Michelle found out that she could have gotten a 2-1/2 percent lower interest rate because she qualified as a "B" credit risk, rather than a "C" credit risk, which this lender put her in.

LESSON SEVEN

HOME SWEET HOME

Three of the most important loans you will ever apply for involve your home. The first, of course, is your mortgage. The second is refinancing your mortgage. The third is the well-known home equity or home improvement loan. There are all sorts of rules and requirements that apply to all of these loans, and you need to know what they are before you fill out your loan application.

Financing a Home

Buying a home is probably the most expensive purchase you will make in your lifetime, so you want to be as informed as possible. Buying a home requires that you have a solid credit history because chances are you are going to have to take out a mortgage loan.

Buying a home is often an extremely emotional experience. However, buying a home is similar to buying a car, only more expensive. You can be happy in a lot of different homes. If one doesn't work out for you, there are others. There is no single house that you just have to have or you will die. The property and the financial terms have to be right for you at that particular time. If they are not, then keep searching for the property and deal that work for you.

There are people who have shopped for a home for years. They feel that the longer they shop, the better the deal they will get. They wait until they find the right property at the right price, with the ideal financing terms. Of course, they could end up waiting forever.

There is a lot to learn before you purchase your home. There are unfamiliar terms that you will need to understand and a whole new group of professionals you will meet. You will deal with larger numbers than you are used to. Prepare yourself for the adventure called "buying your home."

Notice that doesn't say "buying your first home." You may buy your first home when you are in your mid-20's. You may sell that place and buy another when you are in your 30's or 40's. You may find that you actually buy and sell a half dozen or more homes during your lifetime, starting small, getting larger as your family and income grow, and then downsizing as the kids leave the nest and you get older. Each of these transactions will be different. Certainly, the general structure of the deal will remain the same, but the details will change from home to home. You have to pay attention to the terms which are in effect at the time of the transaction. Every time you buy or sell a home, you will need to reacquaint yourself with the ins and outs of buying and selling.

LESSON EIGHT

CREDIT CARDS AND OTHER LOANS

As a consumer, you will be exposed to many different kinds of loans. They come with different terms and interest rates. It is up to you to sort through all the fine print to determine which loans best suit your needs.

There are a number of things you should look for when comparing one loan against another. One difference concerns whether or not you, the borrower, have to provide the lender with collateral in order to get the loan. Another difference concerns whether you are taking out an installment debt or a revolving debt.

Secured Versus Unsecured Loans

Collateral, or security, is a very important concept. A loan secured by collateral is a loan where not only do you promise to repay the money that you borrow, plus interest, you also give the lender the right to sell a valuable piece of property that you own if you fail to keep your promise. This property is often referred to as collateral. Car loans, home mortgages and home equity loans are secured loans because the lender can sell the property in the event you do not make your payments. Remember, even though a lender has collateral, you still must make your monthly payment.

On the other hand, an unsecured loan, like what you owe on a credit card, is a loan where the lender has only your promise that you will make your payments. If you don't make your payments, he may be able to take you to court and get a judgment against you, but there is no property against which he has a claim.

Revolving Versus Installment Debt

Revolving loans such as what you owe on credit cards or lines of credit, are loans where there is no fixed period of time within which you must repay what you borrow. Usually you are required to make a monthly payment, which may be a minimum amount or only the interest which has been added for the month. You can add to the loan, up to your pre-approved maximum credit limit by continuing to charge your purchases.

An installment loan, such as a home mortgage or car loan, calls for a fixed monthly amount to be repaid (including interest), over a set period of time.

Both revolving loans and installments may be either secured or unsecured.

Collateral is King

When you can provide the lender with collateral or security for what you are borrowing, loans can be easy to get, sometimes too easy. Even if you have had a bad credit history, you can probably still get a credit card. It may not be a regular credit card account. You may have

LESSON NINE

YOU'VE GOT TROUBLE WHEN…

It is all too easy to get into financial trouble these days. It can happen to anyone. Financial pitfalls stalk the rich and poor. They follow the young, middle aged, and old. They can strike at any time, quite unexpectedly. The reasons behind financial disasters don't really matter, except to the extent that others can learn from them.

This bad stuff happens more often than you might like to think. Sometimes you can find yourself owing more money than you can afford to repay because of events that are simply beyond your control. However, in too many cases, a person's financial problems are due to the decisions and choices they have made. If you are in trouble with creditors, it may be because you have chosen to live a lifestyle that costs more money than you can afford to spend and now you simply do not have the income and savings to cover what you owe.

It's really not all that difficult to see when you are in trouble. There are the obvious signs. Are you writing bad checks? In some states, that can be a felony and you can go to jail. Are you writing post-dated checks? Are you hoping that a paycheck will make it into your account so the check you have written is good? Are you avoiding telephone calls at home because you know the calls are from bill collectors? Have you had a judgment filed against you? Are you being dragged into court because you are not paying your bills?

Those are the more obvious signs. There are others that are not as easy to recognize. In this lesson, you will learn how to recognize some of the more subtle tell-tale signs of lurking money problems and danger signals. You will also learn to identify poor money management decisions.

The 24 Tell-Tale Signs

This lesson is something like taking your car in for a 24-point check. The mechanic will change your oil, check the oil and air filters, radiator and battery levels, and all those other things that need to be checked regularly to keep your car on the road. You need to do the same thing with your personal finances.

At this point in your credit and personal financial education and experience, you should be able to recognize when you or someone you know is facing a potential problem with money. Right off the top of your head, how many tell-tale signs can you name? What follows are two dozen signs identified by experienced lenders, credit counselors, and regular everyday people. They have seen it all. They have heard every excuse. They have tried to work through every circumstance. While this list is far from complete, it does cover the most common issues people face.

Don't get the wrong idea. Few people are perfect when it comes to their finances. However, the more areas you have problems with, the more likely it is that you are in trouble.

LESSON TEN

WHEN YOU FALL BEHIND

This may be the most difficult lesson in this book for people to understand and deal with. The concept is really quite basic. First, you have to recognize when you have more debts than you can afford to repay. That proverbial light bulb needs to go on in your head so that you realize when you have a problem. Second, you have to prepare a workable plan to repay what you owe. You cannot ignore your debts and hope they will go away. They don't. Ignoring your debts only makes matters worse.

How can you develop a workable plan to repay what you owe when you don't have enough money to cover your debts? As daunting as it may seem, it not only is possible, but people are adopting these plans every day.

The golden rule of dealing with credit problems is: Contact your creditors when you first realize you will be late with a payment so you can explain the situation and work out a realistic repayment plan.

A sudden illness, the loss of your job, or one of a dozen other events may make it impossible for you to pay your bills on time. Whatever your particular situation, if you find that you cannot make your payments on time, you need to contact your creditors. Call them before your payment is late. Try to work out an extended payment plan that reduces interest and waives late fees so your payments are more manageable. If you have paid your bills promptly in the past, your creditors may be willing to work with you. If you have been tardy in the past, don't expect much sympathy. Whatever your problem, do not wait until your account is turned over to a third-party debt collector. At that point, the creditor has given up on you.

You might think, "It doesn't matter if I am late with my payment to the dentist. She's rich. She can afford it if I'm late or if I don't pay." Whether or not the dentist, the clothing store owner, the health club, or any other creditor can afford to stay in business even though you are going to be late with your payment is beside the point. You owe valid debts to these businesses and individuals. These creditors can and will take legal action against you to collect what you owe. Do not be surprised when they do not patiently wait for you to pay if you have not taken the necessary step of contacting them about your financial problem. If they are unsuccessful collecting from you, they may pay a professional bill collector to collect what you owe.

They may go to court if they must to enforce their rights. They may repossess property that you have pledged as collateral for your loan. They may evict you from your house or apartment. They may tell the credit bureau about your nonpayment and ask that the information be entered into your credit file. They may refuse to do business with you in the future. They may garnish your wages.

LESSON ELEVEN

BANKRUPTCY

If you find yourself in a financial situation that you are unable to resolve, bankruptcy can seem the likely solution. Could it happen to you? Certainly it can. Will it? Let's hope not.

Why do people typically file for bankruptcy? Is it due to high medical bills, or is it because they have too much credit card debt? There are a number of circumstances that cause people to file for bankruptcy. Some are avoidable. Some are not. Most cite more than just a single reason.

Judy got clobbered with huge medical bills. "I had medical insurance for my family, but even it wasn't enough to cover all my expenses. I won't bore you with the medical history, but I'll tell you this, a $500,000 medical bill, along with $10,000 a month for drugs, isn't uncommon these days. I just can't pay what insurance didn't cover."

Susan filed for bankruptcy because her business wasn't profitable. "I always wanted to run my own shop. For 4 years, I made a good living doing just that. But when business slowed down, I started using my credit cards and a series of bank loans to make ends meet. Business never improved. I fell into the trap of wanting to believe that business was going to get better. Now I'm trying to pay off over $85,000 worth of business debt, and I can't do it."

Dan's comments were typical. "I just got in over my head with the credit cards. They were too easy. I didn't ask for them. They just kept sending me application after application, saying that I had great credit and was preapproved for still another card. So I took them up on their offers, and it landed me in bankruptcy court. I know it's my fault."

It's easy to see that Dan's situation was avoidable if he had only assessed and tackled his problem before it got out of hand. People say that they get themselves into a financial mess because they lost their jobs or suffered a sizeable cut in the family income. Julie said, "I worked for the same company for 10 years, and then one day they simply did away with my job. It took me almost 2 full years to find something else. I worked part-time but the salary wasn't enough."

Depending on all the details, Julie may have avoided her financial problems.

Some people file bankruptcy because of poor money management skills and bad choices. Terry's story is not unusual. "I wasn't equipped to make good money decisions. I spent money I didn't have. I wasn't a smart consumer. I didn't manage my money, and I didn't budget. I did a lot of impulse buying on credit. I'm in bankruptcy because I never stopped to realize that I couldn't go on spending more money than I was making. I know it sounds stupid, but that's what I did for 4 years and look where it got me."

LESSON TWELVE

BUILDING AND REBUILDING YOUR CREDIT

When it comes to finding a lender who will grant you a loan, perhaps the most commonly heard consumer complaint is, “Why won’t anyone give me a chance?” Or, perhaps, a second chance. On the other hand, the most common complaint about consumers voiced by potential lenders is, “Why don’t people take care of their financial responsibilities so we don’t have to turn them down when they apply for loans?” Fortunately, there is common ground.

It is not particularly easy for people who lack a credit history to begin establishing a good credit record simply because lenders are reluctant to be the first to take a chance. Young adults fresh out of school have complained for generations that they have a terrible time getting that first loan or that first credit card. Today, that first credit card has become all too easy to get as credit card issuers market their cards to younger and younger teens in the hope of gaining brand loyalty.

For those who have handled their credit obligations badly in the past, it is doubly difficult to get a lender to say yes to a loan application.

Nevertheless, establishing and re-establishing a positive credit record can be accomplished, especially given sufficient time.

Life Without Access to Credit

There are a growing number of people who would like to live their lives without borrowing money. They want zero debt. They like paying cash for everything. Their philosophy is, “If I can’t pay for something, I will wait to buy it until I have saved enough money.” Most of these folks have had credit problems in the past and they don’t ever want to revisit those terrible days. So they have no credit cards or loans at the bank, credit union or finance company. They own their cars free and clear because they save until they can afford to pay for a vehicle. Many even own their houses without a mortgage. While they borrow to buy the house in the first place, they tend to accelerate their monthly payments to get rid of the mortgage just as soon as they possibly can.

Take a look at your own budget. Think of how much money you could save and invest if you didn’t have any debts. Recall the statistics which show that the typical person’s installment and credit card debt amounts to 20 percent or so of their income, and installment debt plus mortgage debt comes to better than 35 percent. How well could you live if you had 35 percent more disposable income every month? That’s how people live when they have zero debt to pay.

However, zero debt is, for most people, nothing more than wishful thinking. The fact is, stuff happens. The brakes go out on the car. The hot water heater quits working. The kids need school clothes. When emergencies strike, people use their access to credit.