**Personal Finance Supplement**

**Credit and Debt Payoff Project**

***Learning Objectives***

Upon completion of this project, you should be able to:

1. Define the three types of credit.
2. Determine the type(s) of credit cards that work best for you.
3. Anticipate finance charges you’ll pay when using a credit card.
4. Summarize the benefits and costs of using credit cards.
5. Calculate loan payoffs and create a plan for paying off multiple debt balances.
6. Access and manage your credit reports and credit score.

**Introduction**

Credit and debt are fundamental topics in personal finance. What’s your experience with using credit? How do you feel about it? If you haven’t used credit in the past, why not?

This supplement takes a pro-credit approach, meaning we frame credit as a useful payment tool that *you* control. If you can be a responsible borrower, we are all for using credit cards and taking out loans, especially student loans or a mortgage. Credit cards have many benefits as well, including incentives, rewards programs, and security features.

Of course, being a responsible borrower is not an insignificant requirement. Being responsible with credit and credit cards is central to the pro-credit approach. Some readers may already be that responsible borrower, some may be a work in progress, and others may be struggling with debt. You don’t have to go all in on credit cards, especially if you doubt your ability to be responsible with them. It does mean that you should embrace credit cards as an essential payment tool, rather than a source of credit. While this supplement takes a positive approach to credit, it’s also transparent with the many costs and risks associated with credit and debt.

For most people, credit will always be a part of how you manage money. Framing credit as a useful tool you control means you’re in the driver’s seat. It means you shop around for credit cards and loans with the best rates and fees for your needs, you make on-time payments, and you live within your means to avoid the paycheck-to-paycheck cycle. It also means you understand the makeup of your credit history, measured by your credit reports and credit score. Regularly accessing and reviewing your reports and score ensures you’ll have access to credit and other opportunities like a job or housing rental in the future.

In this supplement, you’ll learn about the three types of credit, types of credit cards, finance charges associated with credit cards, and the many benefits and costs of using credit cards. Next, you’ll compare loans and calculate loan payoffs to understand how loan terms and interest rates affect total payoff values. You’ll then apply this to paying off multiple debt balances, a common scenario for many borrowers. Finally, you’ll learn why your credit history matters and how to access and manage your credit reports and credit score. In addition, the supplement includes a three-part project that applies the topics you’ve learned to your own personal finance journey.

**Three Types Of Credit**

Credit enables you to buy goods and services using borrowed money so you can benefit from the purchase before you have the available cash to buy the good or service outright. Without credit, you’d have to front thousands of dollars for a car before you could drive it off the lot or work several years before you could invest in a college degree. Most people don’t have that kind of cash (or patience!), so they rely on credit for things they want or need now.

The three types of credit are installment credit, revolving credit, and open credit.

***Installment Credit***

**Installment credit** is a type of loan in which you borrow one lump sum and repay it with interest in regular fixed payments, or installments, for a specified duration. When you take out an installment loan, you’re expected to pay back the **principal**, the original amount borrowed, plus **interest**, the cost of borrowing money. If you stop making payments on the loan, the loan is in **default**.

Installment loans are either secured or unsecured. A **secured loan** has collateral to support the debt. **Collateral** is an asset the borrower owns. If the borrower neglects to pay the loan back, the lender can repossess the collateral. Auto loans and mortgages are secured installment loans because they are collateralized by the borrower’s car or house, respectively.

An **unsecured loan** does not have collateral. If the borrower defaults on their loan, the lender is out of luck. Sometimes the lender tries to work with the borrower with revised loan terms, and other times they will sell the debt to a debt collector at a discount. Examples of unsecured installment loans include student loans, personal loans, and **Buy Now, Pay Later (BNPL)** loans. BNPL payment programs are a payment option where consumers purchase an item and agree to pay it back in fixed installments for a specified duration at the point of purchase.

***Revolving Credit***

**Revolving credit** is a type of loan where the borrower can repeatedly borrow and repay amounts from a line of credit up to a maximum limit. If you make the minimum payment or anything less than the monthly balance, interest is charged on any remaining balance after the statement due date.

Credit cards are revolving credit loans. Borrowers use credit cards to make purchases and repayments, up to their **credit limit**. Other examples of revolving credit include a line of credit and a home equity line of credit (HELOC). A **line of credit** is a flexible, unsecured loan from a bank that a borrower can access as needed and repay immediately or over time. A **HELOC** is more common among consumers. Often referred to as a second mortgage, HELOCs are a type of secured line of credit where a homeowner has access to a line of credit, secured by the value of the home minus any existing mortgage(s) on the home.

***Open Credit***

**Open credit** is a type of loan based on the amount of the borrower’s consumption during the billing period. The more you consume, the higher your monthly payment. You’re expected to pay the entire amount in full each month, meaning there’s no such thing as a minimum payment. Similar to credit cards, interest and fees are charged on any balance remaining after the statement due date.

Examples of open credit include utility bills like a water bill, heat and electricity bill, or mobile phone service. While some open credit payments fluctuate month to month, such as a limited mobile phone plan with a fixed amount of data per month, other open credit payments are the same every month, like a mobile phone plan with unlimited data.

**Types Of Credit Cards**

Credit cards look like debit cards and can be used for many of the same purchases. However, when you use a credit card, you’re borrowing from your **credit card issuer**, a bank or credit union that extends credit to qualifying cardholders, like Citibank, Chase, and Capital One. When you use a debit card, you’re paying for a purchase with money that automatically withdraws from your checking account.

It’s helpful to think of individual credit cards as products. There are many credit card issuers and each issuer offers multiple credit card products, each with their own set of features, offers, pricing, and terms and conditions.

***General Purpose Cards***

When it comes to credit cards, you need at least one general purpose card. Cards are either **general purpose**, meaning you can use them at any retailer, or store cards (sometimes called private label cards). Here’s a description of the types of general purpose cards.

* **Cash back rewards cards** have rewards programs that reward consumers for everyday spending categories like groceries, gas, and dining. Rewards are described as a percent of cash back, for instance, 1% cash back. Look for cards that reward you the highest percentages in the categories where you spend the most. You can use one cash back card on everything, or you can leverage multiple cash back cards when you use specific cards on specific categories. Consumers redeem their rewards monthly by electing to have the cash deposited into their checking account or credited to their next statement balance.
* **Travel rewards cards** are either general or co-branded with a specific airline or hotel. Co-branded cards only work well when you tend to stick with the same airline or hotel chain. Travel rewards cards reward consumers for travel-related purchases like flights, hotels, and dining. These cards offer rewards that can be redeemed for cash back or future travel-related purchases that make your cash back amount more valuable when spent on flights and hotels.
* **Balance transfer cards** have low or 0% introductory rates for 6 to 18 months and low balance transfer fees. Consumers transfer credit card balances to these cards so they can avoid interest and pay off the debt within the introductory period.
* **Secured cards** work like any other credit card but are backed by a cash deposit. Secured credit cards are typically issued to consumers with limited or poor credit histories. The purpose of the card is to help the borrower establish or improve their credit history in the safest way possible, because credit is limited up to the amount of the cash deposit.

***Store Cards***

**Store cards** canonly be used in the card’s branded store, like the Target credit card or Home Depot credit card. Store cards come with discounts and rewards you can use on future purchases at the store. You’re probably accustomed to being asked to open one of these when checking out at a store. There’s a reason for that! Store cards are a profitable source of revenue for retail stores.[[1]](#endnote-1) They typically have much higher interest rates than general purpose cards.

While you only need one general purpose card, the optimal number of credit cards for you varies depending on how you use them and your preference for managing them all. You might prefer the simplicity of using one card, or maybe you use a few cards to maximize the benefits that each card offers. Regardless of the number of credit cards you have or want to have, it’s important that you understand what’s available and what’s best for you.

**Credit Card Finance Charges**

Credit cards are primarily used for two purposes. First, as a means of payment to buy something quickly and efficiently, even if you have the cash equivalent to cover the expense. Second, as a source of credit to buy something with borrowed money because you do not have the cash equivalent to cover the expense.

This section covers credit card **finance charges**. Credit card issuers make money from customers who pay interest and fees, known collectively as finance charges.

***Credit Card Interest***

Credit cards use the term **APR**, annual percentage rate, instead of interest rate. APR and interest rate are the same thing when it comes to credit cards. Here’s a description of interest rates on credit cards.

* A **purchase APR** is the interest rate charged on purchases. The average purchase APR is 20.55%, although it varies depending on the borrower’s creditworthiness.[[2]](#endnote-2) If you pay your full statement balance every month, you do not pay interest. If you pay anything less than the full statement balance, you’ll be charged interest using the purchase APR on your next billing statement.
* A **penalty APR** (or default rate) is a very high interest rate charged on purchases when the borrower has violated the card’s terms and conditions. The average penalty APR is 28.96%.[[3]](#endnote-3)
* An **introductory APR** is a low or 0% interest rate charged for an introductory period, like 6 to 18 months. These introductory rates, sometimes referred to as teaser rates, are comparatively low interest rates used to attract new customers.

***Credit Card Fees***

In addition to interest, credit card issuers charge fees that fall into three categories – annual fees, transaction fees, and penalty fees.

* An **annual fee** is the annual cost of using a credit card. You typically want to avoid cards with annual fees, except for cards with exceptional reward programs, which usually have annual fees around $95.
* **Transaction fees** are the costs associated with fixed finance plans, balance transfers, cash advances, and foreign transactions.
* **Penalty fees** are the costs of making mistakes when it comes to managing your credit card. Most credit card companies will charge you an amount up to $40 when your payment is late or doesn’t go through due to insufficient funds in your checking account.

***Paying Your Credit Card***

If you pay your full credit card balance each month, on time, you will not pay any interest or fees. The one exception is if your card has an annual fee. Cards come with a **grace period**, the time between the end of the billing cycle and your statement due date. Grace periods offer credit card users a little time, at least 21 days, where you can avoid paying any interest, as long as you pay your full balance by the due date.[[4]](#endnote-4)

If you do not pay your card off in full, or your payment is late, you’ll pay a finance charge in the form of interest or fees. Credit card issuers are legally bound to make their finance charges and terms publicly available. Sometimes you can skip the fine print, but when it comes to credit cards, reading the fine print is non-negotiable. It’s part of being a responsible borrower and knowing what you’re getting yourself into with every credit card account you open.

Credit card issuers are in the business of making money. When you pay your credit card, have you noticed how they highlight the minimum payment due? It’s often the default payment amount on the monthly bill, usually the first option in the drop-down menu where you are asked how much you want to pay. They practically scream ‘No worries! Just pay the minimum payment and you’ll be good by us.’

The **minimum payment** is the lowest amount you can pay on a monthly credit card balance and remain in good standing with your credit card issuer. It’s calculated as a small percentage of the total balance and may include a finance charge. For example, a minimum payment on a $1,000 balance might be around $20 to $30.

Paying only the minimum payment on a regular basis is the most expensive way to pay off your balance, and therefore one of the fastest ways to get yourself in unmanageable debt. If you continue to use the card for regular purchases, your balance will grow – not shrink – because interest accrues over time. In fact, paying only the minimum payment is *so* dangerous to the consumer, credit card issuers are required to include a warning label on every billing statement that discloses the number of months and total cost it would take to repay the balance if only minimum payments are made each month.

**Benefits And Costs Of Using Credit Cards**

It’s helpful to think of credit card users as one of two types – revolvers and transactors.

* **Revolvers** are credit card users who carry a balance month to month at least once every three months. This means they regularly pay finance charges. 59% of people of all ages who actively use their credit card are revolvers, however the number is considerably higher among younger generations. [[5]](#endnote-5)
* **Transactors** are credit card users who pay their balance in full each month. They use their credit card as a method of payment versus a source of credit. Transactors do not pay interest or fees because they do not carry a balance. 41% of all active credit card users are transactors. [[6]](#endnote-6)

If you’re a transactor, great. If you’re a revolver, you can *absolutely* be a transactor in the future. It’s a matter of paying off your credit card debt – we’ll get to that – then paying attention to your cash flow and financial goals.

***Benefits Of Using Credit Cards***

Do you inherently think of credit cards as *good* or *bad*? Your answer to that question likely depends on your money history and the stories you hear. The reality is, they’re both good *and* bad. That’s because it’s all in how you use them. First, consider the benefits. Keep in mind that most of these benefits are only benefits when credit cards are used responsibly. All the conveniences and rewards in the world are washed out if you cannot manage your spending and get your payments in on time.

* Rewards programs. Free rewards, just for using your credit card. What’s the catch? You just use your card responsibly and earn a percentage of your spending back in cash or other incentives.
* Convenience. Credit cards are easier to use than carrying cash, can be accessed on mobile wallets, and combine your purchases into one account.
* No waiting. Immediate gratification has its downsides, but good or bad, credit cards allow you to enjoy goods and services without waiting.
* Purchase protection. Credit cards provide additional warranties and protection for consumers to dispute charges like defective products or a purchase lost in shipping.
* Fraud protection. If your card is lost or stolen, the maximum liability for purchases made after the card disappeared is capped at $50. Debit cards offer less protection based on when you report the lost card.
* Grace period. Credit card issuers give you a no cost loan for at least 21 days. The grace period helps you manage cash flow, and where else can you get a free loan for three weeks?
* Emergency coverage. Sometimes you need to get out of a bad situation, and a credit card can help you take quick action. Just remember – your credit card, your responsibility – so don’t share your card or login information with anyone, including your partner, so only you can access your card and your credit when you need it most.
* Expense tracking. Credit cards summarize your expenses in one convenient location, allowing you to check in with your spending and make changes based on your financial goals.
* Credit building. If used responsibly, credit cards help you build credit history and improve your credit score, providing you access to more, cheaper credit in the future.

***Costs Of Using Credit Cards***

Next up, the costs. Credit cards have many benefits over debit cards and cash, but not everyone wants to use them as their main means of payment, especially if you tend to overspend. Either way, it’s important to understand all the potential costs of using credit cards.

* Temptation to overspend. One of the biggest drawbacks with credit cards is the tendency to spend more when borrowing money from someone else, versus drawing it from your checking account. While we list convenience as a benefit, it can also be a drawback as credit cards essentially remove the pain of payment that you’d feel if you made the same purchase using cash.
* Risk of overindebtedness. The credit limit on credit cards is your ceiling on how much you *can* borrow, but it’s almost always extraordinarily higher than what you can reasonably pay back given your current and future cash flow.
* Finance charges. When you don’t pay your full balance on time, every month, you’ll pay finance charges in the form of interest and fees. And if you carry a balance month to month, interest and fees accumulate, leading to a debt spiral that can be hard to get out of without a major change in income or lifestyle.
* Teaser rates. Some cards have temporary low or 0% interest rates for an introductory period. This can be a significant benefit, especially when you’re paying down a balance transfer debt, but once the introductory period is over, regular interest rates kick in and you’re back to paying interest.
* Reduced privacy. Lenders often sell your personal information to others for solicitation.
* Identity theft risk. The more credit card accounts you have open, the greater your risk for identity theft, however there are numerous strategies for protecting yourself against identity fraud.
* Financial goals. Overindebtedness and finance charges equals slowed progress in achieving your desired financial goals and investing in your future self.
* Well-being. Credit card debt can lead to financial stress and anxiety, and in some cases damage personal relationships or your personal reputation.
* Credit damage. If used irresponsibly, credit cards can quickly damage your credit history and credit score, making it difficult to access affordable credit in the future.

**Loans**

Now that we have a handle on credit cards, let’s get to some other common types of credit – installment loans, especially consumer loans and student loans.

***Consumer Loans***

**Consumer loans** are installment loans provided by banks, credit unions, and consumer finance companies. Consumers use these loans to pay for a specific expense, like a car, college degree, or consumer product like an appliance and or furniture. Personal loans are also consumer loans, although the intended purpose is unspecified. Recall that installment loans can be secured or unsecured. A loan is secured if it is collateralized with a car, real estate, insurance policy, or money in a savings or investment account. A loan is unsecured if the borrower does not use collateral to secure the loan.

The interest rate on an installment loan depends on the borrower’s creditworthiness and the value of the collateral if the loan is secured. If you’re a lender, would you rather lend $20,000 to a borrower to purchase a car or pay for their wedding? The principal is the same, but the car loan is secured while the wedding loan is unsecured. That means if the borrower defaults on the loan (meaning they stop making payments to you), you can repossess the car. You cannot, however, take someone’s wedding – especially if it already happened! Interest rates are lower on secured loans because they are less risky. Low risk, low interest rate. An unsecured loan, on the other hand, comes with a higher risk. High risk, high interest rate.

The two fundamental factors that determine the overall cost of the loan are the loan’s interest rate and the loan’s term (the length of time you have before the loan must be paid off). The higher the interest rate, the more interest a consumer pays over the loan’s term. The longer the term, the more interest you pay. When you extend the term of a loan, you’ll get a lower payment, but you’ll pay more interest in the long run.

Here’s an example. Mel purchased a $23,400 new car from a car dealership. She agreed to a 72-month loan at 7.2% APR. She’s considering refinancing the loan with her credit union, which offers Mel a 72-month loan with a 2.0% APR, a 60-month loan with a 1.8% APR, or a 48-month loan with a 1.6% APR. For each of the four loans, we calculate the monthly payment, total loan amount, and total interest amount. You can use a loan payoff calculator to replicate the example. We recommend the calculators at Credit Karma, Nerd Wallet, or Smart Asset. [[7]](#endnote-7)

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| --- | --- | --- | --- | --- | --- |
| Loan | APR | Term (months) | Monthly Payment | Total Loan Amount | Total Interest |
| Original Loan | 7.2% | 72 |  $ 401  |  $ 28,872  |  $ 5,472  |
| Credit Union Refi Option 1 | 2.0% | 72 |  $ 345  |  $ 24,840  |  $ 1,440  |
| Credit Union Refi Option 2 | 1.8% | 60 |  $ 408  |  $ 24,480  |  $ 1,080  |
| Credit Union Refi Option 3 | 1.6% | 48 |  $ 503  |  $ 24,144  |  $ 744  |

Mel is better off refinancing her loan at her credit union with all three options. If she keeps the same 72-month term as her original loan, her monthly payment drops $56 and she saves $4,032 in interest over the loan. Mel’s monthly payment increases if she chooses a shorter term, but the tradeoff is saving some interest over the total loan.

***Student Loans***

In 2022, 55% of graduates at public institutions and 57% graduates at private institutions took out student loans to finance their college education.[[8]](#endnote-8) Student loans are either funded by the federal government or private financial institutions.

**Federal student loans** are available to nearly every college student regardless of their credit history. Students apply for federal loans by submitting an annual FAFSA (Free Application for Federal Student Aid). Federal student loans have eight different repayment plans available to borrowers, some of which tie payments to income when you graduate.

**Private student loans** are provided by banks, credit unions, and states. Students apply for private loans directly with the institution, and the availability of the loan, as well as the interest rate, depends on student’s creditworthiness, or the student’s co-signer’s creditworthiness.

92% of student loan borrowers have federal student loans, so we’ll focus on repaying federal loans. [[9]](#endnote-9) First off, you’ll get a six-month grace period on most loans before monthly payments are required. When your loan enters repayment, you’ll automatically default to repaying the loan under the standard repayment plan, although you can request a different repayment plan at any time. You can check out the eight repayment plans at studentaid.gov, as well as compare repayment options and strategies using the website’s loan simulator.

As with any other installment loan, a shorter term with a higher monthly payment means you’ll pay less interest and a lower overall repayment amount over the life of the loan. A longer term with a lower payment means you’ll pay more interest and a higher overall repayment amount.

It’s important to choose a repayment plan that minimizes your total payoff, but also has a monthly payment you can make every month. If you are 15 days late on a payment, your credit score will take a hit. If you become delinquent, meaning you’re 90 days late, your credit will take a big hit. Defaulting on student loans comes with serious consequences. If you’re 270 days or more late on your payments, the government uses the IRS tax refund offset and private debt collectors to recover unpaid debts, and there is no statute of limitations meaning they can try to collect from you during your lifetime.

You are required to repay your student loan, however in very specific situations part of your loan may be forgiven. The **Public Service Loan Forgiveness (PSLF)** is a program available for borrowers with Direct Loans who are employed full-time by a government or non-profit organization and make every single monthly payment for ten years. PSLF should not be your one and only plan. If it is your Plan A, you need a strong Plan B, and you need to be fully committed to working in the non-profit sector, which pays less than jobs in the private sector.

***Debt Payoff***

Let’s say you have more than one debt balance and you want to pay it off so you can move on to other future financial goals. Paying off debt requires two things – a plan and a mindset.

Here’s the basic idea of any debt payoff plan in five steps.

1. Make a list of all debts and estimate the total amount of money you can put towards debt payoff
2. Pick your approach: snowball or avalanche
3. Create a timeline
4. Pay off first debt, pay minimums on others \*, celebrate
5. Pay off next debt, pay minimums on others \*, celebrate, and so on

\* If looking to improve your credit score, pay $10 more than minimum payment on all monthly payments

Now for the mindset. Personal finance is not just about strategies and actions, but also the psychology behind your decisions with money. You’ll be better off executing your debt payoff plan when you take on a debt slaying identity. This means avoiding overspending while you’re paying off your debt. Dig into how you got to your current state. Why did you spend more than your income and how can you avoid this in the future? We also suggest finding ways to celebrate each payoff. That looks different for everyone. Maybe it’s buying something you’ve held off on or taking a day off from work to do something for yourself.

When it comes to step 4, how do you know which debt to payoff first? There are two debt payoff methods, the debt snowball and the debt avalanche. Both strategies get you to the same place, but in a different way. The **debt snowball method** targets debt with the smallest account balance first, regardless of interest rates. Using this method, you make minimum payments on all accounts, and put all extra money towards your smallest debt. You’ll benefit from quick wins which help you stay motivated. The **debt avalanche method** targets debt with highest interest rate first, regardless of account balance. Using this method, you make minimum payments on all accounts, and put all extra money towards debt with the highest interest rate. This method requires time and patience.

Here's an example. Vinny has three debt balances. He owes $1,500 on his Visa with a 24% APR and $38 minimum payment, $3,000 on his store card with a 29% APR and $75 minimum payment, and $600 to his medical provider with no interest and a $100 monthly payment. Vinny’s total minimum payment is $213, but he determines he can put $300 towards his debt payoff plan.

* With the debt snowball approach, Vinny pays the minimums on every account, then an extra $87 a month to his smallest debt – the medical bill – until it’s paid off. Once he’s down to two debts, his monthly payments total $113, which gives him an extra $87 a month to put toward his next smallest debt – his Visa. Once the Visa is paid off, he’ll be left with putting $300 towards the store card balance.
* With the avalanche approach, Vinny pays the minimums on every account, then an extra $87 a month to the debt with the highest interest rate – the store credit card – until it’s paid off. Once he’s down to two debts, his monthly payments total $138, which gives him an extra $162 a month to put toward debt with the next highest interest rate – the Visa. At this point, his medical bill is already paid off since he’s already made six $100 payments on the account.

You can create a plan and calculate payoff values using a debt snowball or debt avalanche calculator. We recommend the calculators at Nerd Wallet [[10]](#endnote-10) and undebt.it. [[11]](#endnote-11) These calculators help you simulate and visualize different scenarios, like putting an extra $50 or $100 to your debt payoff plan each month.

If you are overwhelmed with debt, avoid using a debt consolidation company offering you a debt settlement, which could cost $2,000-$4,000 and not actually reduce your debt at all. You can go to the National Foundation for Credit Counseling ([nfcc.org](https://www.nfcc.org/)) to find a local affiliate for free financial counseling. Other resources include apps and websites like Qoins, Tally, undebt.it, and unbury.me. You can also call your credit card companies and ask for a lower interest rate, and if you have good to okay credit, consider a 0% balance transfer credit card to jumpstart your plan.

**Your Credit Reports and Credit Score**

With credit, you use borrowed money to benefit from a purchase *before* you have the full amount to buy a good or service outright. That’s pretty great, right? Not surprisingly, consumers have become increasingly dependent on credit.

***Credit History***

It’s a privilege when lenders extend you credit. They’re lending you money and they want to get paid back, so they review your history to determine what kind of borrower you are before they agree to a loan and its terms.

The downside? Credit is fragile. It can be beneficial when you have a history of using it responsibly, but it can be detrimental when you have a history of using it irresponsibly. When you do something that reflects negatively on your ability to borrow money and pay it back, lenders and other institutions take notice. That lever becomes a hammer. It could become much more costly to borrow money compared to someone with a proven track record for borrowing money and paying it back. Worse yet, the privilege to use credit may be taken away from you.

An individual’s creditworthiness is determined by two main tools – the credit report and the credit score. We’ll review the ins and outs of each one and how to access them.

*Your Credit History Matters*

Your credit history matters to the people you want to do business with. Before we get into the details of both tools, let’s figure out who’s using them and why.

* Lenders. Financial institutions including banks, mortgage brokers, and credit card issuers use credit history to determine whether they’ll extend you credit and the terms of any future loans which directly impact your cost of borrowing.
* Landlords. Housing applications often require a credit check, allowing potential landlords to review the applicant’s credit history to determine the individual’s ability to pay rent and their overall risk factor.
* Employers. Some employers use credit history to determine an individual’s responsibility, particularly in occupations with high standards for integrity like jobs that deal with money or require a security clearance.[[12]](#endnote-12)
* Insurance companies. Insurers use credit history to set the prices on auto and homeowners’ coverage. Risky borrower equals risky individual, for example, a risky driver, which increases an individual’s monthly insurance payments.
* Utility companies. Some utility companies use credit history to determine the necessity of a security deposit before extending an open credit loan.

In summary, your credit history can affect your ability to get a loan, buy a house, rent an apartment, or get a particular job. Furthermore, even if you can get these things, your credit history will determine the cost of obtaining them. Responsible borrower, better terms. Irresponsible borrower, worse terms.

***Credit Report***

A **credit report** is a detailed summary of an individual’s borrowing history. It’s a multi-page report that lists a consumer’s month-by-month credit history from the past seven years. Consumers have three reports, one from each of the three major **credit bureaus** – Equifax, Experian, and TransUnion. Notably, credit reports do *not* include the consumer’s credit score.

Your credit report has five sections.

1. **Identifying information**. Your credit history is based on your social security number (SSN). This section includes personal information tied to your SSN, including variations of your name, date of birth, and current and previous addresses and phone numbers. This section also details your employment history.
2. **Credit accounts**. This section includes detailed information on your open and closed accounts from the past seven years. For every account, it reports information on the type of account, name of creditor, date opened, credit limit, current balance, account standing, and payment history.
3. **Collection items**. If a debt is unpaid, the creditor can sell the debt to a collection agency, which will show up in this section.
4. **Public records**. These records come from government documents, include bankruptcy filings, foreclosures, and unpaid tax liens. Unlike the rest of your report that tracks your credit history for seven years, public records stay on your reports for up to *ten* years. Stronger public record data standards mean fewer public records are now included on credit reports.
5. **Credit inquiries**. This section lists the financial institutions that have requested access to your credit report, likely because you inquired or applied for a new loan, credit card, rental property, or insurance coverage.

The three credit bureaus are required to provide consumers with one free report, once a year. As a rule of thumb, you should avoid paying for all things credit – your credit report, your credit score, a credit repair service, and a credit monitoring service. To access your credit reports for free, check out these two resources. We recommend saving a pdf of your reports and filing them in a password protected file.

* annualcreditreport.com. Federal law allows you to obtain free reports from all three credit bureaus once a year on this government-sanctioned website.
* Credit Karma. It’s both free and reputable. Credit Karma provides unlimited access to two of your credit reports – Equifax and TransUnion – as well as unlimited access to your VantageScore, and credit monitoring.

It’s a good idea to review your credit report on a regular basis. Reviewing it once a year is the gold standard. Reviewing your report is especially recommended before making any big money moves like finding a new place to rent, buying a car, buying a house, or job searching. Here’s three reasons you should review your reports once a year.

* Find errors or incomplete information. Check your reports to ensure your payments are reported accurately. You have the right to dispute these errors.
* Address any unknown debts or accounts. Check your reports for any outstanding balances you didn’t know about. If you find any new accounts you don’t recognize, this could indicate someone is using your identity to obtain credit.
* Review your credit position. Check your reports to understand the underlying information that makes up your credit score. This will give you a better idea of the strengths and weaknesses of your credit history.

If you find an error or unfamiliar account on any of your reports, you have the right to dispute the error with the credit bureau reporting the incorrect information. To initiate a dispute, go directly to the credit bureau’s website and start an online dispute. The bureau is required to investigate, usually within 30 days. If they deem the dispute valid, the error is corrected or removed. If not, the bureau is responsible for explaining why the report won’t be changed in writing. And remember – the dispute process is free. Be wary of any credit repair or monitoring service that requires monthly payments.

***Credit Score***

A **credit score** is a three-digit number within a specific range that conveys a consumer’s creditworthiness. It’s calculated by credit rating agencies that use information in your credit report, such as the types of credit you use and your payment history. Consumers have multiple scores and different lenders and financial institutions use different scores to make decisions.

The two most commonly used credit scores are the FICO score and the VantageScore. Both scores range from 300 to 850 and interpretations of the ranges vary by score and lender.

There are five factors that make up your credit score. Below we breakdown the FICO credit score and indicate how each of the five factors are weighted in the overall score.

1. **Payment history** (35% of credit score). Credit bureaus track your monthly payments for every line of credit you’ve had in the past seven years. Monthly payments are marked as on time, late, missed, sold to collections, or unreported to the bureau. A credit score is higher when a consumer has a track record of making on-time payments.
2. **Accounts owed** (30% of credit score). Accounts owed is the amount of money a consumer owes to creditors. This factor is measured by **credit utilization**, the ratio of accounts owed to the amount of credit available. Aim for a credit utilization ratio under 30%, but lower is even better and results in a higher credit score. In essence, you want to show restraint in your ability to not use the majority of credit that’s been extended to you.
3. **Length of credit history** (15% of credit score). Your history includes the age of your oldest account, the age of your newest account, and the overall average age of all accounts. A credit score is generally higher the longer a consumer has had credit. However, it’s possible for a borrower with a short credit history to have a high score if the other four factors are favorable.
4. **New credit** (10% of credit score). New credit tracks recently opened accounts. A credit score is higher when a consumer does not open several new accounts within a short period of time.
5. **Credit mix** (10% of credit score). Credit mix is the number and types of credit you have open. A credit score is higher when a consumer has a mix of installment loans, revolving credit, and open credit accounts.

Accessing and tracking your credit score is relatively easy. Use whatever resource you already use, like your bank account, credit card account, or Credit Karma account. Many of the financial institutions you already use offer credit monitoring services, which keep your credit information in a separate section or portal of your app or online account. You can set up notifications and alerts that keep you updated on changes in your credit score.

Many institutions also offer ‘what if’ simulators, which recommend actions you can take to improve your credit score. This type of analysis has come a long way with artificial intelligence and machine learning. As a result, you know the strengths and weaknesses of your five factors and can act on specific recommendations that will make the most impact to improve your score.

**Key Terms**

accounts owed

annual fee

APR (annual percentage rate)

balance transfer credit card

BNPL (buy now, pay later)

cash back rewards credit card

collateral

collection item

consumer loan

credit account

credit bureau

credit card issuer

credit inquiry

credit limit

credit mix

credit report

credit score

credit utilization

debt avalanche

debt snowball

default

federal student loan

finance charge

general purpose credit card

grace period

HELOC (home equity line of credit)

identifying information

installment credit

interest

introductory APR

length of credit history

line of credit

minimum payment

new credit

open credit

payment history

penalty APR

penalty fee

principal

private student loan

public record

Public Student Loan Forgiveness (PSLF)

purchase APR

revolver

revolving credit

secured credit card

secured loan

store credit card

transaction fee

transactor

travel rewards credit card

unsecured loan

**Project Description**

This project asks you to use examples and information from your personal life. Students are encouraged to learn and apply best practices of personal finance using their current money position. This may feel too personal for some students, and in that case, feel free to blur or scratch out information as desired. Alternatively, you can use a hypothetical scenario you might expect for yourself in the future.

***Part 1. Credit and Credit Cards***

1. Types of credit.
2. Define the three types of credit.
3. For each of the three types, provide an example of an account you hold. Include as many details as possible. For example, the interest rate, your payment amount, the number of payments remaining on your installment loan, or if your open credit loan is fixed or fluctuates month to month.
4. Inventory your credit cards.
5. For each card, identify the card type and summarize the card’s rewards program.
6. For each card, record the credit limit, purchase APR, penalty APR, annual fee, and late fee.
7. Reflect on the strengths and weaknesses of your current cards. Does anything surprise you? Do you think you have the right number of cards? Do you have the type of cards that best fit your needs?
8. Research a new card that best fits your needs. Collect the same information on this card from parts a and b.
9. Revolver versus transactor.
10. When it comes to using credit cards, are you typically a revolver or a transactor?
11. If you have a credit card with a balance and continued to pay the minimum payment on the card until it was paid off, how long would it take? And how much would you pay in interest? If you do not have a credit card with a balance, create your own hypothetical example.
12. Benefits and costs of using credit cards.
13. Identify the top three benefits you experience (or anticipate experiencing) using credit cards.
14. Identify the top three costs you experience (or anticipate experiencing) using credit cards.
15. How do your benefits compare with your costs? What does that mean for how you use credit cards, both now and in the future?

***Part 2. Loans and Debt Payoff***

1. Loan comparison.
2. Compare the following four loans for borrowing $15,000. Loan 1: 48-month term with 4% APR, Loan 2: 60 month term with 5% APR, Loan 3: 72-month term with 6% APR, and Loan 4: 72-month term with 10% APR. For each loan, calculate the monthly payment, total payoff amount, and total interest paid on the loan. Organize your findings in a table.
3. What is the relationship between loan term and the loan’s total payoff value?
4. What is the relationship between APR and the loan’s total payoff value?
5. Your student loan debt.
6. What type of student loans do you currently have?
7. Find your student loan debt total and add additional loan amounts you estimate you will take out prior to graduation. If you do not have student loan debt, respond to the questions using a hypothetical scenario of future student loan debt to finance your education. Using the standard repayment plan, calculate your monthly payment, total payoff amount, and total interest paid on the loan.
8. Using the two alternative repayment plans, calculate your monthly payment, total payoff amount, and total interest paid on the loan.
9. Reflect on your results. What repayment plan will best fit your future budget and financial goals?
10. Debt payoff.
11. Using your own debt balances (see answer to Part 2, Question 2), create a debt payoff plan. If you do not have more than one debt balance, add a realistic debt balance you expect in the future to your debt payoff plan, such as buying a new car or adding your student loan payment to your debt once you graduate.
12. Try at least four different repayment scenarios. Organize your findings in a table.
13. Comment on your preferred strategy - snowball versus avalanche.

***Part 3. Credit History***

1. Consider your credit history.
2. Describe two situations in which someone might access your credit history in the near future.
3. Will your current credit history help or hurt these situations?
4. Access and review your three credit reports.
5. List your installment, revolving, and open credit accounts.
6. Do you recognize the credit inquires? What types of institutions do they represent?
7. Does anything surprise you or look unfamiliar?
8. Access and review your credit score.
9. Do you regularly check your credit score? If so, how? If not, how can you receive regular updates on changes in your credit score?
10. What are two things you can do to improve your credit score?
11. There’s a lot of misinformation surrounding credit scores. Research and describe three myths of credit scores.
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