Financial Well-being

Debt and Credit

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When evaluating financial wellness, debt has a real impact on your ability to reach your goals. Debt feels like a “four letter word.” However, it can also help you meet your long-term goals related to owning a home, continuing your education, and more.

The use of debt is not black and white and although debt is not evil, you should limit your debt to reach your financial goals.

Most of America is dealing with some form of debt. The Federal Reserve, the central banking system in the United States, did a study in 2015 and found that the average American had $5,700 in credit card debt and 31% of Americans had applied for credit in the last 12 months.

The challenge with debt is that compound interest, interest paid on interest, can add up and make it feel like it is impossible to pay off your debt. However, it is not impossible if you have a plan!

Here is an example:

Let's say you have a $5,700 debt and assume you have 18% interest rate. If you only pay the minimum payment each month, it will take you 19 years to pay off the debt and you will end up paying close to $5,500 in interest alone. That means your $5,700 debt actually cost you $11,200 – almost double of what you started with!

It is easy to see why it feels impossible to get your debt paid off. The reality is that you can pay off your debt, but paying the minimum payments is not the path to success.

Although getting out of debt will take a lot of work, it is an important step toward financial security. To prepare you for this challenge, we have included an overview of debt basics in this section.

Let's start

If you are dealing with debt, you may be looking for a quick fix to wipe it out. Unfortunately there is no quick fix, but the good news is that there are some basic steps you can take to help get your debt under control:

1. Change your monthly spending habits and avoid living beyond your means. Avoid the behavior that helped create your debt whenever possible so you don't continue to add to your debt. Creating an emergency fund will also help you cover those unexpected expenses. Refer to our Financial Well-being - Savings document for help on setting up an emergency fund.

2. Check your credit – go to **www.annualcreditreport.com** and request your free annual credit report. This report provides a list of your credit accounts, including balances and interest rates.

3. Focus your efforts and pay off one debt first. Don't try to pay them all off at the same time. It is recommended to start with the debt with the lowest balance and pay as much as you can on that debt using your discretionary funds (i.e. money left after you pay your bills or buy basic necessities like food, etc.). Continue to pay the minimum on all of your other debts. Although you want to pay the debt off fast, it is important that you don't overextend yourself and not have enough money to cover your other monthly expenses or exhaust your emergency fund. Maintain a balanced approach, but ensure that you pay more than the minimum balance on one debt.

4. Ask for a reduction on the interest rates on the debt that you are not focusing on paying off first. If you are a long-standing customer and have a good payment record, you have a good chance of getting a lower rate. Talk to the financial institutions and use the lowest interest rate that you have as a reference point and try to get your other credit institutions to lower their rates to that lowest level. The first person that you talk with may not agree to the lower rate, so be firm and ask to speak to the supervisor and plead your case. If you have paid your bills timely on an older account, make sure that you mention your long-standing relationship with the lender and strong payment history.

5. Beware of the quick fix or offers too good to be true. Debt consolidation offers will most likely not reduce your debt, but rather just extend the amount of time that it takes to pay your debt off. Meaning you have the same amount of debt just longer to pay it off and more interest cost, causing you to pay more in the end.

How much debt should I have?

In general, the less debt you have the better off you are financially. However, you may be able to reach your financial wellness goals even if you have some debt. Here are some general guidelines that mortgage lenders use to determine whether or not you have too much debt based on your gross pay (your total income before taxes or other payroll deductions):

Housing Costs – the amount you pay towards your house (includes monthly mortgage principal and interest, taxes and insurance costs) should not exceed 28%.

Total Debt – housing costs plus reoccuring debt payments (i.e. credit card, car loan, child support, or alimony payments) should not exceed 36%.

Here is an example:

Jan and Joe are trying to borrow money to buy a new house. The gross income for the couple is $60,000 a year.

Current debts:
- $1,000 a month on credit cards and a car note.
- $800 a month in child support.

The new house they are interested in has a purchase price of $250,000 and their future monthly house payment is estimated to be $1,350 a month (principal, interest, taxes and home insurance included).

Let's recap:

Annual Income = $60,000

Monthly Income = $5,000 (60,000 / 12)

Monthly Housing Costs = $1350

Monthly Reoccuring Debt = $1,800 ($1,000 for credit cards and car note and $800 for child support)

% of Gross Income spend on Housing Costs
$1,350 / $5,000 = 27%

% of Gross Income spend on Total Debt =
($1,350 + $1,800) / $5,000 = 63%

Based on this example, the housing costs are below the 28% of threshold of gross income. However, the total debt exceeds 36% of gross income. Jan and Joe would be considered high risk and would not be rated favorably by the lender.

As noted above, you are not rated favorably if you have exceeded either of these debt percentages. You may qualify for a FHA (government backed) loan with a slightly higher total debt, but it will make it harder to live within your means monthly and is generally less desireable. Keep in mind, your total debt level is just one of the factors which impact your ability to get a loan and your interest rate.

Improving your credit profile

When you are trying to get credit for the first time or have had financial difficulties, it may feel like the financial world is against you. No one is out to get you, but most of these decisions are based on your credit rating. In addition to lenders, a variety of other parties, such as insurance companies, use your credit information when they interact with you. Obviously, the better the credit rating is, the more favorable you are going to be treated.

Financial institutions evaluate your credit worthiness based on the 3 C's:

1. Capacity – Can you repay the loan based on your income and current debt load? Refer to the guidelines above on how much debt your should have.

2. Character – Financial institutions typically don't know you personally so they evaluate your character based on your credit history. Did you repay previous loans? Did you make those payments timely? Lenders use the data on your credit report to make these determinations on your character.

3. Collateral – Is there an item that can be used to secure the debt? In other words, if you don't pay, is there an item that the bank can take possession of and sell to recover some of their loss. The most common type of collateral provided for personal loans is either a home (mortgage) or a car (auto loan).

Your credit report and score

The main way to improve your credit profile is to improve your credit score. A credit score is a basic evaluation of an individual's risk related to the repayment of debt. The higher the score the better, 850 is the highest score and has the lowest risk and 350 is the lowest score and has the highest level of risk. Why is this important?

Basically, if you have a lower score (more risk) the bank is going to charge you a higher interest rate – if they allow you to borrow from them. They may not approve your loan because they are worried that you may not repay them according to your credit agreement.

Here is some benchmark information from 2013 to help you to determine how your score compares to the rest of the nation.

FICO Score (Credit Score)	Percentage of the Population (as of 10/2012)
300-499	6%
500-549	8.5%
550-599	9.9%
600-649	10.1%
650-699	12.2%
700-749	16.2%
750-799	18.8%

Review your credit score yearly. You are entitled to a free credit report every year from each national credit reporting company (Transunion, Experian, and Equifax) or whenever a negative action is taken against you based on your credit report information. You can download your annual credit report at **www.annualcreditreport.com**.

Since your credit report is how outside parties evaluate your credit profile, it is important that you understand what is listed on the report and how the score is calculated. Here is a breakdown of the basic types of information on your credit report and what percentage of the credit score is based on this information:

1. **Your Credit History (35%)** – this area includes information related to what accounts you have held, when they were opened or closed, what balance you had, and whether or not you made monthly payments ontime and paid, at least, the minimum amount. Avoiding late payments will help improve your score. If any of the data on your credit report is incorrect and you have documentation that shows that your credit history is wrong, you can dispute that information and request that it be corrected.

2. Amount Owed (30%) – this portion of your score is based on the % of total available credit limit that you borrowed and owe at any given time for each account open, as well all debts added together. To improve your score, make sure that you don't owe more than 50% of your available limit on any account. Less than 33% is even better. Experts suggest that you limit your credit balance to 30% or less of your overall credit limit.

3. Length of Credit History (15%) – the longer that you have had credit the better.

4. Credit Inquiries (10%) – if more people are inquiring about your score, you are considered to be a greater risk.

5. Mix of Debt (10%) – the different types of debt you carry. Debt where you borrow and pay an equal amount monthly over time (i.e. auto loan) is considered to be more desireable than revolving loans (i.e credit cards).

In general, if you are trying to improve your credit score you should spend most of your time on 1 and 2; clean up any errors in your report history and reduce the amount owed.

Next steps

If you are having problems paying your bills and accounts are going into collection, or you are worried about losing your home, we would suggest that you seek the help of an expert.

If you are looking for general information to manage your debt (choosing a credit counselor, settling credit card debt, filing for bankruptcy), credit repair, debt relief, and debt collection (your rights, collection arbitration, the statute of limitation related to debts), we would suggest that you first look at the materials that the Federal Government provides related to "Dealing with Debt" at **www.consumer.ftc.gov/topics/dealing-debt**.

Other resources

- Need a calculator to evaluate your loans, interest rates, etc? – try **calulator.me**

- For general information about the credit reporting requirements and your rights, including your rights related to identity theft, visit the CFPB's (Consumer Financial Protection Bureau – Federal Government) tools and resources at **www.consumerfinance.gov/learnmore/**

- For more information specifically related to how your credit report is used, review the document provided by the Consumer Financial Protection Bureau at **http://files.consumerfinance.gov/f/201604_cfpb_list-of-consumer-reporting-companies.pdf**

Debt may be a “four letter word”, but it doesn’t have to prevent you from meeting your goals. Take action and put together a plan to improve your debt and credit situation today. Remember, financial wellness is a journey. Keep taking baby steps toward your goal – **you can do it!**