4 CREDIT AND DEBT: SMART WAYS TO USE THEM

When Nick bought his guitar, he saved the money to buy it. He could also have borrowed the money from his Mum and Dad… but then that wouldn't be Nick!

Once you're 18 you have other options if you're buying something and don't have the cash at hand – you can use credit. Credit means someone is willing to lend you money – called principal – in exchange for your promise to pay it back, usually with interest. Interest is the amount you pay to use someone else's money. When you use credit you go into debt.

Australians use it more often.

Did you know that Australia has one of the world's highest rates of personal credit?

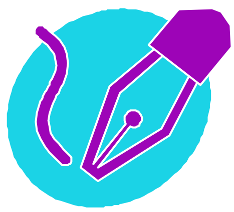
That means that more Australians are using credit for their day-to-day purchases, rather than cash.

If not looked after or managed properly, credit can get you and your family into all sorts of trouble and cause lots of unneeded stress.

It's VITAL to understand how to manage credit and debt, so it works for you rather than against you.

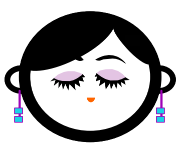
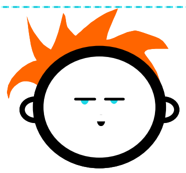
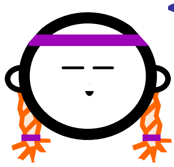
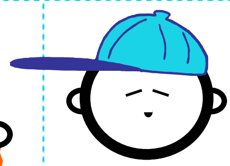
There are many different ways to obtain credit – credit cards, loans and mortgages. The different types are designed for different needs, but they all follow the same basic pattern: buy what you want now, and pay for it later. It sounds like a good deal, but there is a catch!

Yep, you've got to pay for using credit – it's not money for nothing.



Who'll get into trouble?

Who do you think is most likely to get into trouble with debt…? (Rank them from one to five, with one being the most likely.)

				
Kim's splurges?	*Nick's rock star dreams?*	*Lena's obsession with all things basketball?*	*Daniel's addiction to cars?*	*Mel's uni costs?*
☐	☐	☐	☐	☐

In Unit 3 we saw how compounding helps you earn money on your savings and investments. The bad news is that debt is an area where compounding can work *against* you.

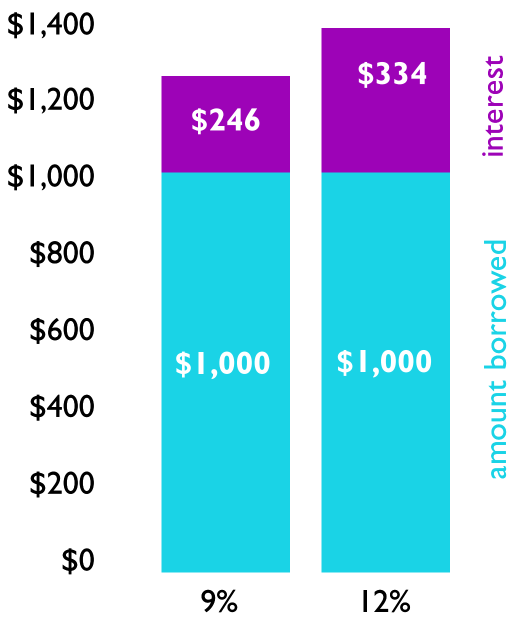
When using credit there are three things that increase how much you end up paying…

1 The higher the interest rate, the more you pay

When you pay interest the rule is, *the higher the rate, the greater the cost.* To make it easy to compare costs, interest is expressed as an annual percentage rate – the rate tells you how much extra you will need to pay each year.

Compare two loans, both for $1,000 for five years, but with different interest rates. The first loan has a rate of 9%, while the second is 12%.

In this example, the higher interest rate means the loan costs an additional $88. Although that's not necessarily a lot of money, if you think of a loan for hundreds of thousands of dollars, higher rates can add substantial costs to borrowing.

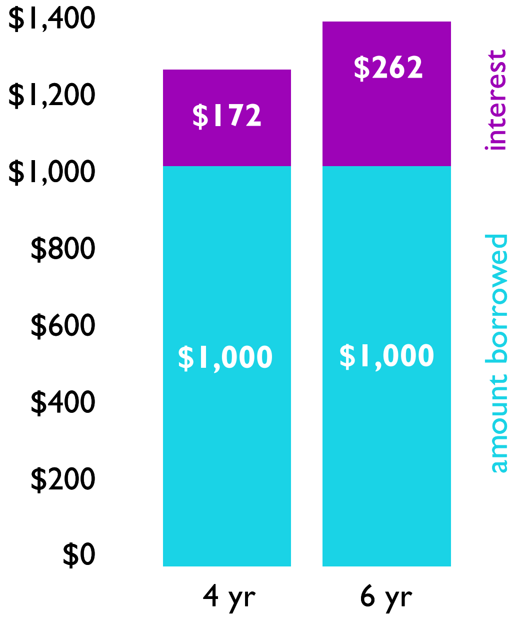


The greatest cost of credit is the interest rate, so there are real advantages in finding a lower rate…

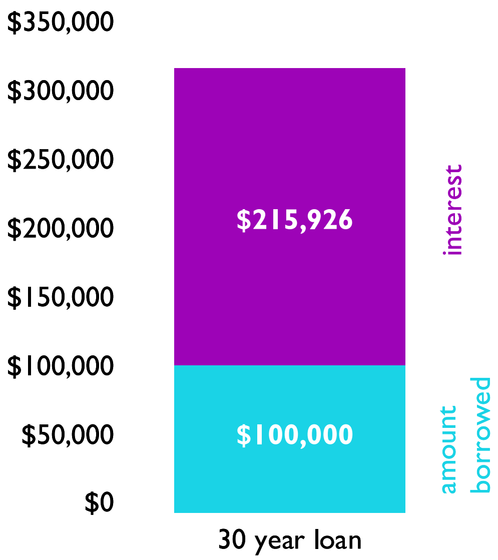
2 The longer the term of the loan the more you pay

Another key piece of information you need to use credit wisely is the term of the loan. In other words, how long the loan lasts. The rule here is, *the longer the term, the greater the cost.* That's because the longer you keep a loan, the more time you are paying interest, and the more money you are costing yourself.

Compare two loans, both with an interest rate of 8% and an identical amount of $1,000. But, they have different loan lengths – one for four years, the other for six.



Notice that it costs an extra $90 for an additional two years of loan repayments. That doesn't sound like much until you think of it as an extra $90 for every $1,000 borrowed. Imagine the additional costs if you were looking at a $10,000 or even $100,000 loan!



To put it into perspective, let's say you've found the house of your dreams. You take out a $100,000 home loan (mortgage) at 10% with a term of 30 years – a common length for a house. How much will you really be paying for your home, if you pay off the loan as scheduled?

In effect, you bought one house but paid for three! The point? The longer the length of the loan, the greater the overall cost to you.

3 Fees and charges

Of course, borrowing money isn't free, so there are a range of fees associated with using debt. These vary, depending on the kind of debt you have and the lender. Some of the more common fees are listed below.

Annual fee. Most often used by credit card companies, an annual fee is a yearly charge for having a credit card.

Establishment fee. Usually associated with home loans, this is a charge for setting up a loan.

Exit fee. If you want to move your loan from one lender to another, some lenders will charge you a fee for leaving (usually this only happens within the first few years of the loan).

How credit can help you

Now that you know some of the costs, you may be wondering if using credit is worthwhile.

As with many financial tools, it depends on your situation. Credit does have potential benefits… if you know what you're doing and you're responsible.

Access to cash in an emergency. When you need money to pay for something in an emergency, like a tow truck if your car breaks down, having a credit card can get you back on the road quickly.

The ability to use it now. Borrowing money allows you to own or benefit from the use of large purchases now, such as a car or a house. Without loans, most families would probably not be able to buy a home or even a new car.

Safety and convenience. Charging a purchase on a credit card helps avoid carrying large amounts of cash. When you're travelling, major expenses like hotel rooms, airfare and car rentals can all be put on credit cards. Also, many purchases can be made over the phone or on the Internet with a credit card.

Earn rewards. Credit card issuers frequently advertise that cardholders can earn rewards – the more you use the card the more bonus points you get. You can redeem points for a variety of rewards such as holidays, tickets, cash, vouchers, and so on. It's an attractive benefit, but it usually isn't free. Cardholders typically pay for credit card bonuses through a higher interest rate or fee. Smart consumers weigh the value of rewards against the higher cost of using a particular card.

You can borrow money from lots of places. Banks and credit unions offer credit cards, car loans, personal loans, and home loans (mortgages). Car dealers often provide financing for cars, and many department stores offer their own store cards. Some universities and financial institutions offer student loans for education. Let's look more closely at the specifics of some of these forms of credit.

Credit cards (VISA, MasterCard, Bankcard and AMEX)

A credit card is synonymous with "buy now, pay later." Credit card companies have made it easy and convenient to use their cards for purchases and to get cash when you want it. Shops, restaurants, movies - everywhere you turn you see signs saying credit cards are accepted. Unfortunately, being so easy to use often means big bills later on.

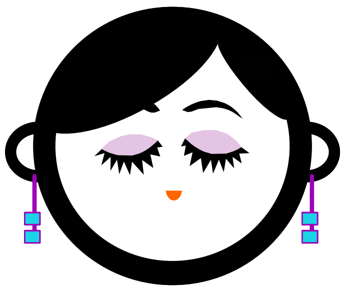
Unlike many forms of debt, there is no loan term with credit cards. That means you can pay what you owe when you want to. This is where many people get into trouble because the longer it takes to pay the balance owed on your credit card, the more it costs you.

Check the cost

Recent changes mean that you now may have to pay extra to use a credit card.

Previously, business owners paid this cost, but now they are able to pass it on to their customers. When you have a credit card, make sure you check what additional costs you may be charged before buying.

How long can it take?



Kim has fulfilled her dream of having her own credit card. But with a $2,000 credit limit, she's maxed-out her card in just a few weeks. This card requires a minimum payment of 2% of the balance, or $20, whichever is greater. If she pays the minimum amount each month how long will it take her to pay off her card when the interest rate is 18%?

More than 18 years! Plus she'll have paid over $3,500 in additional charges. In other words, Kim will end up spending $5,500 over 18 years just so she can enjoy $2,000 today. And that's if she doesn't use the card for the next 18 years… which is highly unlikely! She's put herself in debt very quickly and she's fast getting out of control.

Credit card basics

Interest rate. Credit cards can carry interest rates as high as 20%. At that rate, you know what damage compounding can do to your wallet! Compare all costs on credit cards and look for the lowest rates, especially if you do not expect to pay your balance in full each month.

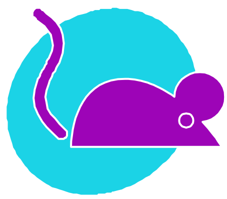
Annual fee. Some cards charge an annual fee. Often the fee is waived if you spend more than a specified amount.

Interest free period. Most cards offer a period during which no interest charges apply. The key is to pay off the entire balance of your card during the period. A typical interest free period is 55 days.

Minimum payment. Many credit cards require a minimum monthly payment of 2-3% of your purchases. Some set a minimum dollar payment, such as $15 per month. While making small payments like these may seem easy, remember that the remainder of your balance is compounding at the card's interest rate – and that's high compared with other types of debt. Your balance can easily build up and before you know it, you can be out of control.

Credit limit. All cards come with a credit limit or the total amount of purchases you can make on the card. Once you've reached your limit – say $500 – your card is "maxed out." At that point, you can't make any new purchases until you reduce the balance owed. Higher limits may sound good, but you need discipline to avoid running up big loan amounts. If you're like Kim and tempted to spend as much as you can lay your hands on, remember that big purchases quickly compound into large interest payments.

Picking the best deal



It can be difficult to know which credit card or financial institution is offering the best deal. Complete the chart below to compare what's available. Firstly, tick the card you want to compare:

☐ *VISA* ☐ *MasterCard* ☐ *Bankcard*

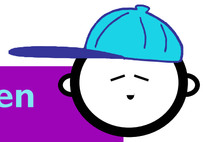
Then, go to www.moneymanager.com.au and compare what the four big banks offer:

Bank	Interest rate	Annual fee	Interest free period	Minimum payment
ANZ				
Commonwealth Bank				
National Australia Bank				
Westpac				

Personal loans

If you need a loan for a large purchase, such as a car or holiday, you can take out a personal loan. Personal loans require you to make payments on a regular basis, usually monthly, until the loan is paid off. Banks and credit unions offer personal loans for many purposes, while car dealers offer them in conjunction with a third party, and only for car purchases.

Interest rates on personal loans are generally lower than credit card rates. Credit cards let you vary how much you borrow and pay back from month to month. However, with personal loans you borrow a set amount. The loan amount, loan term, and your payments are fixed for the life of the loan, which is typically two to six years.



Daniel finds heaven

It's a beaten up Holden HZ ute that he knows he can do up… new wheels, tray and sports kit should do the trick.

He's now 18, but can't afford the car – he could get a car loan for $10,000 at 9% interest for 48 months. He'd have to repay about $249 per month. At the end of four years, he'd have paid the lender about $11,950. Borrowing will increase the cost of his dream car by about 20%… but he reckons it's worth it.

It's usually best to pay off a loan as soon as you can. But with any type of loan, it's a good idea to check for prepayment penalties – these are penalties for paying off your loan early.

Student loans

If you're heading off to uni, you may need some help paying for it. Student loans are offered by banks, credit unions, and some universities.

Student loans usually carry low interest rates. Depending on your income level, some of the loans allow you to delay making payments until you finish your education.

HECS

If you do go to uni, you'll also be hit with the Higher Education Contribution Scheme (HECS). HECS is a way to ensure that students contribute to the cost of their education. There are payment choices:

- You can either pay it up front before you start studying and receive a 25% discount
- Pay at least $500 of your HECS contribution up front and defer the rest. You will receive a 25% discount on the part you pay up front
- Defer paying your contribution until you start working

If you choose the second or third option, your HECS contribution is, in effect, a loan. It's something you'll have to pay for once you start earning an income.

The impact of different loan factors

Using a loan calculator on the Internet, complete the chart for the following loans. We've helped, but there are some blanks you need to fill in for monthly payment and loan length. At the end, work out how much interest you have paid on the loan.

Loan Balance	*Interest Rate*	*Monthly payment*	*Loan length*	*Interest*
$5,000	*10%*		*4 years*	
$5,000	*10%*		*6 years*	
$5,000	*12%*		*6 years*	
$5,000	*12%*	*$200*		
$1,000	*8%*		*2 years*	
$1,000	*19%*	*$20*		
$1,000	*12%*		*5 years*	

Home loans (Mortgages)

Some day, if you buy a home, you'll probably need to take out a mortgage. It works much like a personal loan, except the length of the home loan extends over a longer period of time – usually 15 to 30 years – and the amount borrowed is usually much larger. Interest rates on home loans are usually lower than personal loans.

Banks and credit unions have come up with many different types of home loans - some have a fixed interest rate, while others have a rate that can change over time. There are also many other features available depending on your needs. It's complex so when the time comes it's worthwhile getting some advice from an expert.

Loans for phones

When you buy a mobile phone on a plan, you're using credit. Why? Because you are not paying for the phone upfront. Instead, you enter into a contract to pay a minimum amount each month for a certain time period. Therefore, your phone plan is a type of loan, and as with other loans, you pay for the privilege of getting something before you have completely paid for it.

When looking for a new mobile phone, think about how much the phone would cost you upfront vs. how much you end up paying for it through a contract. This isn't as easy as it sounds because contracts often include special offers for call costs and monthly charges – it makes it hard to compare. There are many websites that can help, which include questions to ask before signing a contract – www.aca.gov.au or www.tio.com.au are good places to start.

If you do go onto a contract, there is another factor to consider. If you spend more on phone calls and messages than what you agreed to in your contract, you are charged for it. This is why so many people get into trouble with huge monthly mobile costs… they don't realise that they've gone over their contract amount until they get their phone bill. For this reason, many people prefer prepaid phones, because they know exactly how much it is costing them.

Did you know that 45% of 14 – 24 year old Australians have a mobile phone? That is one of the highest rates in the world! And a quarter of these people struggle to pay their mobile phone bills…

Getting a rating

When you apply for a credit card or loan, lenders assess how likely you are to repay the amount. They do this by checking your credit rating, which is simply a history of your personal (or family) financial transactions for the past seven to ten years. Your credit record contains information about loans you've applied for, loan amounts you received, and whether you paid your bills on time (or not at all).

How do you build a good rating? Don't bounce cheques, make regular deposits into your savings account regardless of their size and always pay your bills when they are due. Once you have a loan, make your repayments on time. If you handle a little debt responsibly, lenders are more willing to extend larger amounts to you in the future.

You can't get a credit card or loan from a financial institution on your own until you turn 18. However, some banks and credit unions allow parents or guardians to be "guarantors". This means they guarantee to pay your debt if you can't. Having a guarantor is a financial responsibility in itself: if you don't pay your bill, your guarantor has to – legally and financially.

Rights and responsibilities

When you sign the application for a loan or a credit card, you've agreed under the law to uphold what's written in the agreement. That means you're agreeing to repay a loan and interest on time. These are your personal financial responsibilities. If you fail to keep your part of the bargain, lenders may take legal action against you to recover what they can.

You should not assume that a lender will necessarily refuse to provide credit if you cannot afford to make the repayments. You should always make it your own responsibility to decide whether you can afford the repayments.

How much is too much?
Setting yourself some limits on how much debt you have can be a good idea. A maximum of 20% of your net income – your take-home pay after taxes – should go toward all of your loan payments (excluding a home loan). That means your credit card payments, car loan, and any other loans you have. And most lenders don't want to see more than 33% of your take-home pay being used on a home loan payment.

As a consumer, you also have rights that lenders must respect. Before you enter into a contract, make sure you receive a document setting out your rights and obligations, as well as other important information about the loan such as:

- Amount of credit
- Interest rate
- Amount, frequency and total amount of repayments
- All fees and charges

TOP 10

Top ten questions to ask yourself before you sign on the dotted line.

1. Do I really need this item right now or can I wait?
2. Can I qualify for credit?
3. What is the interest rate?
4. Are there additional fees?
5. How much is the monthly payment and when is it due?
6. Can I afford to pay the monthly payments?
7. What will happen if I don't make the payments on time?
8. What will be the extra cost of using credit?
9. What will I have to give up to pay for it?
10. All things considered, is using credit worth it?

When your debt's out of control

Getting out of debt is a lot harder than getting into it. But there's one simple rule to follow: spend less than you earn! This is one place where your budget comes in handy. If you consistently spend less than you earn, you can use the additional money to pay off your debt.

If you have several loans, try to make the minimum required payments on all of them. If you can't, always try to send at least some money to all of your lenders. Talk with them, and let them know you are doing what you can to pay them back.

If there's money left over after you've made your minimum payments, use it to begin paying off one loan at a time. Start with the loan with the highest interest rate – not the loan with the largest balance.

When that loan is paid off, apply the money to the loan with the next-highest interest rate. Keep the process going until your overall debt is back under control.

So if you ever find yourself drowning in debt, follow this process: focus on your budget, spend less than you earn, and begin to pay off your loans.

What happens if things get really bleak and you can't pay off your debts? Well, you are declared bankrupt. This means a court will order you to give up control of your money and assets (like your house and car) to a "trustee". The trustee can be a person or company that has the power to sell your assets and pay off your debts. Being declared bankrupt is far from fun and is definitely the last option… downsides include being refused credit, being unable to pay for anything by cheque if it's over $3,000, being unable to leave Australia without the court's approval, and if you own your own business, you must tell everyone you do business with that you are personally bankrupt.

Getting help

If you feel that you are getting out of control, talk to someone. The worst thing people do is put this off, because it only makes the situation worse. Community financial counselling services have been set up to help with all types of financial related problems including:

- Having more debt than you can deal with
- Harassment by debt collectors
- Debt recovery through the courts
- House eviction, disconnection of utilities (gas, water, electricity)
- Uninsured car accidents, tax debts and unpaid fines

They can help you:

- Organise your financial information
- Design a budget
- Suggest ways to change and improve your financial situation
- Assess eligibility for government assistance
- Negotiate with creditors
- Explain debt recovery procedures, bankruptcy and other alternatives
- Refer you to other services (e.g. gambling, family support, family counselling or legal aid)

Where do you find them?

ACT
- Care Financial Counselling Service 02 6257 1788

NSW
- Financial Counsellors' Association 0500 888 079
- Wesley Mission Credit Helpline 1800 808 488

Northern Territory
- Anglicare NT Financial Counselling Service 08 8948 2700 or 08 8985 0000

Queensland
- Credit Help Line 1300 887 400
- Financial Counselling Services Qld 07 3257 1957, www.fcsq.org
- Lifeline Creditline 13 11 14

South Australia
- Adelaide Central Mission 08 8202 5180
- Parra Districts Community Legal Service 08 8281 6911
- Dept. of Family and Community Services 08 8226 7000

Tasmania
- Anglicare Financial Counselling Service 03 6234 3510
- Consumer Credit Solicitor at Hobart Community Legal Service 03 6223 2500 or 1800 232 500

Victoria
- Financial and Consumer Rights Council 03 966 32000
- Credit Helpline 03 9602 3800 or 1800 803 800
- Financial and Consumer Rights Council lists all financial counsellors in Victoria http://avoca.vicnet.net.au/~fcrc/

Western Australia
- Financial Counsellors Resource Project 08 9221 9411
- Consumer Credit Legal Service 08 9481 7665
- Financial Counsellor's Association of WA 08 9325 1617

Whether you're prone to Kim's spending sprees, someone like Nick who avoids debt, or somewhere in the middle of the two, understanding credit and debt is something that could have a big impact on your future.

Used wisely, a manageable amount of credit can help you make your way through life quite happily. It may give you the opportunity to travel, to further educate yourself, or to buy your first home.

But there is a catch and it's a big one! You pay a price for using money that is lent from someone else. So before applying for that credit card, think about what you're like with money, and whether you're the right person to handle debt well (or not). Be smart about it and you'll be set to enjoy all the perks of credit without the headaches!

Turn to the next page to think about the pros and cons of using credit.

Pack your bags

Woo hoo! You've just won a holiday to Los Angeles – accommodation, food and sightseeing all paid for. All you have to do is save up $2,000 for the return airfare and some spending money.

A condition of the prize is that you have to take the trip within twelve months. The piggy bank is empty, but luckily you've got options. You can:

1. **Put the plane ticket on your credit card and leave within the month. You can also use your credit card to pay for anything you want to buy while you're away.**

2. **Delay the trip until you save up enough money for the ticket and spending money.**

You know if you go with option 1, it means you won't be able to pay your credit card off within the interest free period, but you are confident you can meet the minimum payments each month.

Each option has pros and cons. Use the table to help you decide what you would do. To get you started, we've listed a couple of suggestions – all you have to do is put them in the right column… and possibly add a few of your own.

OPTION 1 Leave soon and pay by credit card		OPTION 2 Delay your trip and save before you go	
Pros	Cons	Pros	Cons

Pay more than $2,000

Free travel insurance is possible when you pay this way

Pay interest

No interest payments

Immediate satisfaction

Only pay $2,000

Unforseen events may affect you taking your trip

Earn additional interest and increase spending money

Have to wait for your holiday

Reduce credit available for emergencies or other purchases