6. Understanding Credit and Using It Wisely

Introduction

Credit is a wonderful tool that has allowed many people to achieve goals they might not have otherwise been able to achieve, such as buying a home or paying for higher education. However, credit has also been the downfall of many people who have not used it wisely. Understanding both the positive and negative aspects of credit will help you be wise as you pursue your financial goals.

The credit card can become a very destructive financial instrument if not carefully watched and controlled. If credit card debt gets out of control, it can cause not only financial troubles but personal heartache as well. Gordon B. Hinckley said, "Debt can be a terrible thing. It is so easy to incur and so difficult to repay. Borrowed money is had only at a price, and that price can be burdensome."[1]

Objectives

This chapter focuses on the following four objectives to help you better understand credit reports and credit cards:

1. Learn the principles of using credit wisely
2. Learn about credit bureaus, credit reports, and credit scoring
3. Identify appropriate uses for credit cards and explain how they can help you achieve your financial goals
4. Learn how credit cards work and describe the costs involved
5. Learn how to manage credit cards and open credit

Principles of using Credit Wisely

Proper understand of the principles of using credit wisely can help us to be wiser consumers of credit. Following are a few principles of using credit wisely which may be helpful as to try to minimize the use of credit.

1. Know what you want out of life. Know yourself, your vision, goals, plans and values. It is important that you have an idea of what you are trying to accomplish so that you can slowly become that vision of yourself. Make sure that everything you do is consistent with the things you are trying to accomplish and the values you hold dear.

2. **Know where you are financially**. This is especially important in regards to your

budget, assets and liabilities. Hide no bills from your spouse and make sure you understand all assets and liabilities.

3. **Keep current on all bills**. Pay off all credit cards and other debt monthly—you do not need a balance to build credit. Set a goal to not go into debt except for those things that the prophets and apostles have counseled. Work hard to not spend money you don't have.

4. **Make only planned purchases from your budget**. Only make purchases that are in your budget and that are planned for, particularly large purchases. Use this planning time each quarter or month to wisely determine your needs and wants, and then to plan accordingly.

5. **Be wise in your use of credit and debt**. Don't go into debt except for a modest home and modest education. Do not fall for the monthly payments trap that says you can pay a certain amount each month.

6. **Review your credit score and credit reports annually**. This is to ensure correctness and no identity theft which is becoming more prevalent. Work to improve your credit reports and raise your credit score to above 750 if possible.

Learn About Credit Bureaus, Credit Reports, and Credit Scores

Credit bureaus are private companies that collect and report information from creditors, public records, and various institutions. There are over 1,000 different credit bureaus; the three major ones are Equifax, Experian, and TransUnion.

Credit reports are files of information that credit bureaus compile about specific individuals. Most individuals who have any type of credit (credit cards, checking accounts, loans, etc.) have a credit report.

The information on your credit report is very detailed. It includes personal demographics, such as your age, social security number, previous addresses, employment history, and criminal convictions. The report also includes information about your credit history, including a list of any inquiries you have made about your credit in the last two years. Factors that determine your credit worthiness include your annual income, how long you have lived at your current residence, how long you have been employed at your current job, and how many bank accounts and credit cards you have. Other factors that determine your credit worthiness include your age, your employment history, and your credit history.

Although the information gathered by the credit bureaus is about you, it may not always be correct. It is estimated that 70 percent of Americans have at least one negative remark on their credit reports, and almost half of all credit reports contain incorrect or obsolete information.

You have specific rights related to your credit reports. If you are ever denied a line of credit, you can request a free copy of your credit report from each of the credit bureaus. If you would like to review your credit report, you can request a free copy once a year from each of the three major credit reporting agencies (Equifax, Trans Union, and Experian) by going to www.annualcreditreport.com and filling out several forms.

You should review your credit report from each credit bureau once a year to make sure there are no mistakes on it. Even simple mistakes can result in a lower credit score, which may prevent you from getting a mortgage or a consumer loan; these mistakes may even increase the cost of your auto insurance.

When you are reviewing your credit report, look for open lines of credit that you were not aware of and other indications that someone may be committing fraud by using your information. If you think there are mistakes on your credit report, you need to have them investigated. If an investigation does not clear up a mark on your credit report, but you still disagree with it, you can add a personal statement of up to 100 words to your credit report explaining what happened with a specific creditor. When you apply for credit, potential lenders can see your explanation of what happened and consider it when they make their lending decisions.

Credit evaluation is the process potential creditors use to determine whether or not an individual deserves to be given credit. This evaluation is based on an analysis of specific financial information from various sources.

A credit score is the result of that credit evaluation. Financial institutions developed credit scores as a way of determining which borrowers are most likely to repay their loans. While for students a GPA is based on grades, for borrowers a credit score is based on factors such as credit history, length of credit, repayment history, and types of credit owed.

Your credit score takes into account specific factors surrounding your debt and debt habits. You are assigned a single score that lending institutions use to base their decisions on whether you qualify for credit. Your credit score also determines what interest rate you will pay on the credit an institution offers you. Generally, the higher your credit score, the lower the interest rate you will have to pay.

One of the most important investments that may be affected by your credit score is a loan for a new home purchase. Your credit score can have a significant impact on whether or not you get this type of loan: nearly 75 percent of all mortgage loans are sorted according to credit scores. Your credit score may also affect the cost of your insurance. For these and many other reasons, understanding credit and maintaining a high credit score are important to your overall financial health.

Research by E-Loan showed the following statistics on how credit scores affected what interest rate consumers paid on loans (see Table 1).

Table 1. Credit Scores and Interest Rates Paid[2]

Credit scores above 760 paid 3.27 percent.
Credit scores from 700 to 759 paid 3.49 percent.
Credit scores from 680 to 699 paid 3.67 percent.
Credit scores from 660 to 679 paid 3.88 percent.
Credit scores from 640 to 659 paid 4.31 percent.
Credit scores from 620 to 639 paid 4.86 percent.

For a $300,000, 30-year loan with monthly payments, the difference in how much someone with a credit score of 760 (3.27 percent) paid in interest compared with how much someone with a credit score between 620 and 639 (4.86 percent) paid was significant; there was an increase in interest payments over the life of the loan of $99,275 on a $300,000 loan. There is a direct correlation between your credit score and the interest rate you pay.

What Is a FICO Score?

The most common type of credit score is the FICO score, which was developed by Fair, Isaac, and Company of San Rafael, California. Fair, Isaac, and Company is not the only credit scoring company, but lending institutions use FICO scores more often than the credit scores provided by other companies. Lenders usually base your interest rate on your FICO score, which can range from 300 to 850. Generally, the higher your FICO score, the lower the interest rate lenders will charge you. There are three main FICO scores, including FICO Score 8 (which is the most widely used), FICO Score 2, which is used for mortgage lending, and FICO Score 8 which is used for auto financing.

Before 2001, consumers were not allowed to see their credit scores. However, in March 2001, new legislation allowed the public to access their credit information for a price. You can now purchase a copy of your FICO credit score from www.myfico.com or purchase credit scores from other credit scoring and reporting companies, such as Experian, TransUnion, and Equifax. I generally recommend purchasing a FICO credit score as these are most used in the industry. Please also note that promotional codes for MyFICO are generally available on the Internet (search “MyFICO promotional code”). Getting a copy of your credit report and credit score does not affect your credit score.

How Is Your Credit Score Determined?

There are a number of different institutions that calculate credit scores. Since the FICO score is the most common, this chapter will discuss how your credit score is determined based on the FICO scoring methodology.

About 35 percent of your credit score is based on your payment record. This is why it is important to pay your bills on time. Do what the scriptures and our leaders have counseled: do not get into debt in the first place, if possible. If you are in debt, make timely payments, and get out of debt as soon as you can.

Another 30 percent of your credit score is based on the total amount you owe as a percent of your available credit or credit limit. Generally, try to keep your usage of credit below about 15 percent of your available credit limit. Keep your balances low, especially on revolving debt. If you are hoping to get a mortgage loan in the future, it may be wise to pay off your revolving credit every week so that the amount you owe is a small percentage of your total available credit.

Around 15 percent of your credit score is based on the length of your credit history. You should keep your oldest accounts open whenever possible to show you have learned to manage credit over a longer period of time. However, you do not want to have too many accounts open at one time.

Approximately 10 percent of your credit score is based on your application history. Do not apply for credit too often. If you are applying for a new credit card every quarter, the question arises as to what you are doing with your available credit. For most people, one to three credit cards is generally sufficient. Realize that each time you apply for credit it is noted on your credit report.

Finally, 10 percent of your credit score is based on a credit mix. You do not want to have too many of the same kind of card. Having a Sear's, Nordstrom's, and Kohl's card may actually bring down your credit score because they are all similar stores. Be cautious of retail stores that offer a 10- to 20-percent discount on your first purchase if you apply for their store credit card. These types of cards can have negative effects on your credit score.

What Should You Do Regarding Your Credit Score?

Just as you manage your assets carefully, you should manage your liabilities carefully. You must take an active role in managing your credit score. Ideally, you should review your FICO score every two years and review your credit reports annually; do these things more often if you are planning to take out a loan for a house within the next 12 months. By planning ahead, you can resolve any inaccuracies on your credit report before you apply for a loan; planning ahead can help you get the highest credit score—and the lowest interest rate—possible.

Identify Appropriate Uses for Credit Cards and Explain How They Can Help You Achieve Your Financial Goals

There are five main benefits for using credit cards:

1. **Emergencies*:*** Credit cards can be useful when you don't have cash on hand and need to pay for something immediately, such as an auto repair or an insurance co-payment.

2. **Reservations*:*** Credit cards can be used to guarantee hotel rooms, rental cars, and other rental items. This is an important use, especially if you travel.

3. **Convenience*:*** With a credit card, you can buy things over the phone or on the Internet. Credit cards make purchasing things very easy. They also provide you with a record of everything you spend, an important bookkeeping benefit.

4. **Cash flow and timing*:*** If something is on sale, and you know you have the cash coming in a week, you can actually buy the item before you pay for it. In this way, you can take advantage of sales (but remember, you do not save money by spending).

5. **Free services*:*** Often, credit cards offer rewards, such as extended warranties, travel insurance, airplane miles, gasoline rebates, and cash rebates—all of which can reduce the overall cost of some items.

While there are benefits to using credit cards, there are drawbacks as well. Credit cards must be used wisely to avoid problems. The following is a list of some of the problems associated with using credit cards:

Increased spending: People don't take as much time to think about how much they're spending when they use a credit card. Research has shown that, on average, people spend 30 percent more with a credit card than they do with cash.

Losing track of spending: It's easy to lose track of what you spend with your credit card. It requires discipline to track the charges you make.

Interest and other costs: Interest charges can range anywhere from 8 percent to 25 percent. In addition to these interest charges, you must take into account compounding periods, annual fees, and other miscellaneous fees, such as cash advance fees and balance transfer fees. Often, the costs of using credit cards are double or triple the costs of using other types of loans.

Obligations on future income: Most importantly, when you use credit cards, you put obligations on future income. As you take on more debt, you not only obligate future income, but you also limit future flexibility should emergencies arise.

<u>Using a Credit Card Effectively</u>

The following are some important keys to using your credit card effectively:

1. **Know your personal and family goals.** What do you want to accomplish individually and as a family? What do you want to accomplish financially? A leading financial publication recently reported that the average baby boomer will pay $1,200 in interest annually. That is a lot of money. Instead of paying interest, why not use that money to attain your financial goals?

2. **Spend money only on things planned for in your budget.** If you understand your goals, and if your budget is consistent with your goals, you will buy only things you have planned for in your budget. If expenses you hadn't planned for arise and you decide they are necessary expenses, you will have to go back and revise your budget to make them work.

3. **Do not go into debt.** It is wise to not go into debt except for a home or an education.

Follow this advice and avoid credit card debt whenever possible.

4. **Use wisdom in deciding what to buy.** Use wisdom in your expenditures. Learn to get away from the "buy now, pay later" mentality, and adopt the "save now, buy later" mentality.

Learn How Credit Cards Work and Describe the Costs Involved

Companies issue credit cards to earn money. Annual fees can be anywhere from $0 (no fee) to $300 a year. Interest rates are high: some are as high as 25 percent before compounding! Balance transfer fees can also be very high—they can start at 3 percent and increase with each transfer. Cash advance fees usually start at 4 percent and can go higher. Often, these fees can't be paid back until the original, less costly debt is paid back; this results in even higher costs to you. Penalty rates sometimes exceed 25 percent, and late fees are also high. All of these charges are added on top of a 1.5 to 5 percent charge to merchants.

How Credit Cards Work

A credit card is one type of open credit. Open credit is an agreement you make with a financial institution (in this case, a credit card company) that allows you to borrow money up to a specific limit; it is expected that you will pay back the loan at a specific interest rate and pay other attached fees as well. Many factors determine how much open credit will cost you annually: the balance owed, the interest rate, the balance calculation method, the cash advance costs, the annual fee, and the additional penalty fees.

By understanding how open credit works, you can avoid the pitfalls this type of credit can present. There are several key factors you should understand about open credit before you apply for this type of loan:

Interest rate: Credit card companies state the interest rate as an annual percentage rate, or APR. This is the true, simple interest rate that is charged over the life of the loan. However, the APR does not take into account compounding periods or the time value of money (see **Chapter 9—Time Value of Money**). You should also watch out for teaser rates. Teaser rates are introductory rates used to attract new customers (some are as low as 2.9 percent) but these rates change after a specified period of time. Don't be fooled—read the fine print.

Compounding period: The compounding period is how often interest is charged to your account. Most credit card companies compound interest daily. It's interesting to note that when you save money, interest is compounded monthly, but when you borrow money, interest is compounded daily. Any time you borrow money, remember that you are paying interest, not earning it.

Balance calculation methods: You should understand that credit card companies use three main balance calculation methods: average daily balance, previous balance, and adjusted balance. The most commonly used method of calculating your balance is the average daily balance. This method adds up your average daily balances for each day during the month, divides the total by the number of days in the month, and multiplies the result by your monthly interest rate (your APR divided by 12). The previous balance method is the most expensive method. This method takes the previous balance you owed last month and multiplies it by your monthly interest rate. The last method, the adjusted balance method, is the least expensive. This method takes your previous balance, subtracts your payments, and multiplies the total by your monthly interest rate.

Cash advances: Avoid using cash advances. Cash advances are an extremely expensive way to borrow money. Interest begins to accrue as soon as you get a cash advance because they are not considered normal credit card charges. Generally, the interest rate charged on cash advances is higher than the interest rate charged on purchases. In addition, there is usually a cash advance fee of between two and four percent of the cash amount advanced. Moreover, some cards require you to pay the purchase balance before you can pay the cash advance balance so that the credit card company earns the higher interest rate for a longer period of time.

Grace period: A grace period, or period over which you do not pay interest on new purchases, normally lasts from 20 to 25 days. The grace period excludes cash advances and often doesn't apply if you carry over a balance from a previous month. If you do not owe a balance for the previous month, a grace period means that you could avoid paying for a purchase for nearly two months. However, you need to watch out because not all credit cards offer a grace period.

Credit card philosophy: Before you apply for open credit, you should determine your personal credit card philosophy. What kind of credit card user will you be? There are three main types of credit card users: credit users, convenience users, and combined convenience and credit users. If you use your credit card to borrow money you don't have, you are a credit user. Credit cards are one of the most expensive ways to borrow. Credit users typically carry a balance from month to month. If you are a credit user (it is not a good idea to be one), look for a card with a low APR.

If you use your credit card only because it's convenient, you are a convenience user. Convenience users generally pay off their credit card balance each month. If you are a convenience user, look for credit cards that offer low annual fees, long interest-free grace periods, and free benefits.

Combined convenience and credit users need to balance the interest rate and the annual fee to obtain the lowest overall cost for the card. Find the card that best matches your needs.

Learn How to Manage Credit Cards and Open Credit

Open credit can be either good or bad, depending on how you use it. There are five keys to managing your open credit:

1. Reduce Your Balance

If you have a balance, commit to reducing it each month. Do not take on any additional debt. You need to set a goal to reduce your balance and then just do it. Commit to remaining debt-free.

2. Protect Yourself against Fraud

You should save your credit card receipts. At the end of the month, compare your receipts to your statement. Once you have done this, you can destroy the receipts. Use caution when giving out your credit card number, especially over the phone. In addition to these precautions, be aware of where your cards are at all times. Never leave a store without your credit card.

If your credit cards are lost or stolen, there are a number of things you must do, and you must do them quickly. First, you should call your credit card company immediately. Make sure you have a photocopy all of your credit cards, front and back, and keep the toll-free numbers for your credit card companies handy so you can report any loss or theft. Put your credit card information in a safe place.

Second, you should immediately file a police report in the jurisdiction of the loss. This shows the credit card company that you are serious, that you are diligent, and that you are trying to find your credit card.

Third, you should call the three national credit-reporting organizations and the Social Security Administration to place a fraud alert on your name and social security number. The phone numbers for all four organizations are listed below:

Equifax:	888-766-0008
Experian:	888-397-3742
TransUnion:	800-680-7289
Social Security Administration fraud line:	800-269-0271

3. Be Aware of Signs of Trouble in Credit Card Spending

Consider the following questions:

- Do you make only the minimum payment each month?
- Have you reached your credit limit on any of your cards?
- When you dine with friends, do you pay the entire bill on your credit card and then have your friends reimburse you with cash?
- Do you wait for your monthly bill to determine how much you have charged?
- Do you get cash advances because you do not have enough in your checking account to pay bills or other expenses?
- Have you been turned down for credit or had a card canceled by a credit card company?
- Have you withdrawn money from savings to pay off credit card bills?

- Do you think it is too much trouble to figure out how much of your credit card bill is interest?
- Does your stomach start churning when you get your credit card bill?

If you answered “yes” to any of these questions, you may be having some trouble managing your credit card spending.

4. Control Your Spending

Part of controlling your spending is committing to always live on less than you earn. If you have problems doing that, cut up your credit cards. If nothing else works, use the envelope method of budgeting. The envelope method involves placing money for each budget category in an envelope. When the cash in the envelope for a particular budget category is gone, you have nothing more to spend in that category.

5. Opt Out

One final option is to “opt out.” Do you want to stop receiving credit card applications in the mail? There is a national credit opt-out number you can call to take your name off the mailing lists of all four major credit-reporting agencies. Dial 1-888-567-8688 (1-888-5OPTOUT). You will be asked for your home telephone number, name, and social security number. You will then be sent a form to fill out and sign. After doing this, you will have much less junk mail. You can also opt out on the Internet by going to www.optoutprescreen.com. After you fill out the information on the site, you will be immediately removed from the mailing list for credit card applications for five years.

Opting out is easy and painless and can also help eliminate some types of credit card and identity fraud.

Summary

We have discussed credit evaluations, credit reports, and credit scores. Understanding how these matters impact you is critical, especially if you are looking to buy a house. Your credit score not only influences how much you will pay for a mortgage (or other types of credit) but it also influences your insurance costs.

There are appropriate uses for credit cards, and they can be useful in helping you attain your personal goals. Credit cards can be used for emergencies, reservations, convenience, cash flow, and free services.

There are several drawbacks to having credit cards. When you have credit cards, you are more likely to spend more, lose track of spending, pay higher interest rates and fees, and obligate future income. You need to be very careful if you use credit cards.

Before you apply for a credit card, consider the interest cost (or APR), compounding period, balance calculation method, costs for cash advances, and grace period. Depending on the reasons behind why you use credit cards, you are either a credit user, one who uses the card for borrowing; a convenience user, one who uses the card only for convenience; or both a credit and a convenience user.

Open credit can be either good or bad, depending on how you use it. The five keys to managing your open credit are

1. Reduce your balance.
2. Protect yourself against fraud.
3. Beware of trouble signs in credit card spending.
4. Control your spending.
5. Opt out.

Understanding credit and using it wisely are important parts of the modern financial world.

Assignments

Financial Plan Assignments

Your assignment is to evaluate how you are doing in managing credit wisely. Since credit evaluation and credit scoring are important tools in the acquisition of a home and other important purchases, it is important that you understand where you stand.

Start with downloading learning ***Tool 1-07*** template on ***Credit Use: Cards, Reports and Scores***. For Credit Cards, answer the following for each credit card you have (bold items are required--see Chart 1: Credit Card Rates). If you have no credit cards, state that you have no credit cards and complete your action plan on views of future debt and perhaps your plan to obtain a credit card.

Your next assignment is to get a copy of your credit report. If you are from the United States, you can, by law, obtain one free copy of your credit report each year from one of the major credit report suppliers (Experian, TransUnion, or Equifax). Go to www.annualcreditreport.com and supply the necessary information. You will select one of the major providers and input the necessary identification information, and the credit reporting agency will provide you a copy of your credit report online. You can also go to www.myfico.com; for about $19, you can get both a copy of your credit report (from your choice of supplier) and your FICO credit score.

Once you have your credit report, read it thoroughly and ensure it is accurate. If there are problems, follow the process we discussed to improve your score and remove inaccuracies from your credit reports.

Finally, go and obtain your credit score. This score is used by many industries to determine the type of credit risk you are. While we prefer a FICO score, which is used by 85% of the industry, you are welcome to go to free locations, such as www.creditkarma.com review your credit score (they actually use VantageScore 3.0). it can give you an idea of how others see your credit usage. They generally will use either the TransUnion or Equity credit data to calculate your score.

Read through your credit score report in detail. Write down the things you can do to improve your credit score and work on them.

The under your Action Plan, what are the things you are going to do to improve your credit usage and to be better at wisely managing credit?

Chart 1: Credit Card Rates

Annual Percentage Rate for Purchases (fixed or variable)	%
Cash Advance APR (fixed or variable)	%
Balance Transfer APR (fixed or variable)	%
Overdraft Advance APR (fixed or variable)	%
Variable Rate Information (Index is ________________)	
Purchase And Balance Transfer APR (Index + ___.__%)	%
Cash Advance APR (Index + ___.__%)	%
Default APR (Index + ___.__%)	%
Grace Period (in days)	
Method of Computing Balance for Purchase	
Annual Fee	
Minimum Finance Charge	
Transaction Fee for Balance Transfers	
Transaction Fee for Cash Advances	
Late Payment Fee	
Over-the-Credit-Limit Fee	
International Fee	
Credit Limit	
Date Opened (if available)	

Learning Tools

The following Learning Tools may be helpful as you prepare your Personal Financial Plan:

18. Credit Card Repayment Spreadsheet

This Excel spreadsheet helps you determine how long it will take you to pay off a specific credit card or loan based on the balance owed, annual percentage rate, compounding periods, and payments per month.

9. Debt Amortization and Prepayment Spreadsheet

This Excel spreadsheet is a debt amortization and prepayment schedule to help you reduce and eliminate your debt.

20. Debt Elimination Schedule with Accelerator

This spreadsheet allows you to input your different debts and interest rates. It then prioritizes that debt based on interest rates and creates a repayment plan based on the minimum payments due each month. This repayment plan is consistent with Marvin J. Ashton's plan in the article "One for the Money." This spreadsheet also allows you to include an accelerator amount and an amount in addition to your normal monthly payments; you will be able to see how long it will take you to pay off your debt.

Review Materials

Terminology Review

CD Laddering: the process of getting a higher interest rate by buying longer term CDs and purchasing them more often. For example, 1 month CD rates are too low, but you like 6 month rates. Take the amount of money you want to invest, divide it by 6 (or any number), then invest 1/6 of your money every month in a 6 month rate. You are creating a ladder of CDs, and every month you have money coming in. You would then reinvest that in another 6 month CD.

Corporate bonds: Debt instruments issued by corporations to fund the requirements of the companies.

EE Bonds: US government savings bonds where the interest rate is set every 6 months and tied to current market interest rates.

Equivalent Taxable Yield: This is the yield you would need to earn on a fully taxable security to give the same after-tax return that you receive on a tax advantaged security, i.e., a security that has specific tax advantages (i.e., tax free for Federal or State or both).

I Bonds: Inflation linked US government savings bonds, where the rates on the bonds are tied to inflation.

Money Market Account or Money Market Deposit Account: A non-financial account that pays interest based on current interest rates in the money markets. They typically require a higher minimum balance to avoid monthly fees and typically have a higher rate of interest.

Savings Bonds: Bonds issued by the US government with tax advantages to encourage savings.

Review Questions

1. What is the difference between a credit evaluation and a credit report?
2. How can you obtain one free credit report per year from each of the three credit bureaus (Equifax, TransUnion, and Experian)?
3. What should you do if you find an error on your credit report?
4. What are the benefits of having and maintaining a high credit score?
5. What are the five most important factors in determining your credit score?

Case Studies

Case Study 1

Data

Steve and Adrianna Tanner recently graduated from college and started their first jobs. Based on their combined salary of $90,000, the bank pre-approved them for a home loan, and they found the perfect house. However, when they went in to finalize the loan, they were told they did not qualify for the loan because of their low credit scores.

Application

A. What didn't this couple do?
B. What should they have done?
C. What can they do to remedy the situation?

Case Study 1 Answers

A. Steve and Adrian Tanner did not determine their credit score before applying for a loan. Do not leave things to chance! If you know your credit score, you may be able to get a lower rate for your loan.
B. They should have reviewed their credit reports and tried to resolve any problem areas before applying for a loan. They also should have gotten their credit score to see how they were perceived by the financial community.
C. They can get their annual credit report free from each of the three agencies we discussed, and they can pay to get their credit score. They should then work to improve their credit score so they can get the lowest rate possible for a loan.

Case Study 2

Data

Steve carried an average daily balance of $600 this month. His balance last month was

$1,000, and he made a $900 payment on the 15th of this month.

Calculations

Calculate the monthly interest charges for credit card accounts that charge interest rates of 10 percent, 16 percent, 18 percent, and 24 percent.

Fill in the following chart:

	10%	16%	18%	24%
Average daily balance	$5.00	____	____	____

Application

Since the average daily balance is the most commonly used method of calculating balance, how important is it to get a low interest rate?

Case Study 2 Answers

Calculations

The formula for calculating your finance charge is your average daily balance multiplied by the interest rate divided by 12 months.

	10%	16%	18%	24%
Average daily balance	$5.00	$8.00	$9.00	$12.00

Application

If you use credit cards to finance spending (which is not recommended), it is important that you get a low interest rate on your card.

Case Study 3

Data

Bill was reading about the importance of keeping a high credit score and got his FICO score of 690. He heard a rumor that to improve his FICO score, he needed to reduce the number of cards in his name. Bill canceled three of his five credit/bank cards that he had not used in a long time. The next time he got his FICO score he discovered it had dropped by 40 points.

Analysis

A. List three possible reasons why his score may have dropped.
B. What should he have done to make sure the canceled cards helped, and not hurt, his score?
C. What might he do to improve his score?

Case Study 3 Answers

A. There are three possible reasons his score may have dropped:

1. *History:* One of the cards he canceled had the longest history. His score may have dropped as his time with credit was lessened due to the dropped card.

2. *Available credit:* Each of the canceled cards had a large amount of available credit. When these were canceled, they decreased his total available credit and increased his percentage usage each month, resulting in a lower score.

3. *Mix:* Perhaps the cards canceled resulted in a mix of credit that was biased toward one type of card. This may have lowered his score.

B. He should have done the following to make sure his score did not drop:

1. *History:* He should have made sure the cards he canceled did not have the longest credit history.

2. *Limit:* Before dropping the cards, he should have gone to his existing credit/bank card companies and requested an increase in credit limit, at least to match the amount he had previously. If they would not increase the limit, he should have kept the old cards.

3. *Mix:* Even though the cards may not have been used, if they had given a better mix, it may have been wise to keep them. He should have avoided having too many of the same types of cards.

C. The following are things he might do to improve his credit score:

1. *Payment record:* Tighten his budget and save 20 percent of his income. Pay bills on time and don't miss!

2. *Amount owed:* Use that 20 percent and any additional money to pay down debt (after he has started his emergency fund). This will reduce his amount owed and his usage of available balances.

3. *Limits*: Call his credit card companies and request an increase in credit limits. This will help his use of available balances.

4. *Credit history:* Ask his parents to include him on one of their credit cards (I am not sure I would do this).This will increase his credit history (this is called piggybacking, and it works only for families, not individuals).

5. *Application history:* Do not apply for new cards. Generally, I recommend between two

to four cards for most individuals. Do not get new cards just for store credit.

6. *Credit mix:* Do not apply for too many of the same type of cards.

Case Study 4

Data

Bethany, a BYU student, was reading about the importance of having a high credit score. She went to www.annualreport.com but found she has no credit history. She pays her bills on time, has a checking account, and has a debit card.

Questions

A. Why might she not have a credit report?
B. What can she do to improve her credit history?
C. Does a debit card help build credit?
D. If banks will not allow her to get a credit card, what could she do?
E. How could she get a secured credit card?

Case Study 4 Answers

A. She may not have credit history because she has not had much credit. Even though she pays her bills on time, the bills may be in other students' names. She may also be an international student without a social security number.
B. She could try to get a credit card. This would be helpful to her in improving her credit history.
C. A debit card does not help build credit.
D. If she cannot get a credit card, she should (carefully) look into a secured credit card. If she can find one with low fees, she will put money into the card and can charge up to the amount of money on the card. Credit reporting agencies cannot tell the difference between a credit card and a secure credit card.
E. She should check with her bank or www.bankrate.com for a card that does not charge an application or insurance fee and that has a low annual fee.

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[1] "Thou Shalt Not Covet," *Ensign*, Mar. 1990, 4
[2] http://myfico.com, 2 May 2012