Understanding debt & credit scores

Understanding debt is critical to financial well-being. The decisions you make about when and how to borrow money can impact your finances for a long time.

What is bad debt?

Bad debt is when you use credit cards to purchase disposable items or durable goods and don’t pay off the balance in full.

A common example of creating bad debt is using a credit card to purchase clothes. Clothes are typically worth less than 50% of what you pay for them when you walk out of the store. Each month that you make only a partial payment on your credit account, you are charged interest. The disposable or durable item you purchased continues to lose value, and the amount you paid for it continues to increase. You will ultimately end up spending more than the cost of the goods purchased by the time you pay off your credit card. Opening retail store credit cards to purchase clothes is even worse, as these credit cards come with high interest rates along with credit inquiries that negatively impact your credit score.

To see exactly what you might be paying for your purchases over time, use this minimum payment calculator to determine the real cost of paying only the minimum payment on credit card.

What is good debt?

Good debt is investment debt that creates value. Medical education loans, real estate loans, home mortgages and business loans are all examples of good debt. Additionally, taking on debts that are tax-deductible and debts that produce more wealth in the long run are also good debts.

In some cases, taking out debt with a lower interest rate to pay off a debt with a higher interest rate can be a beneficial use of financing. As a rule, financing for something that is considered good debt usually has a lower interest rate than financing for something that is considered bad debt.
Credit cards

Credit cards have many benefits. Most significantly, they enable us to have what we want now and let us pay for it later. In fact, credit cards provide interest-free debt for up to 45 days from the date of purchase, depending on when in your billing cycle your purchase is made.

If you carry a balance from month to month, the interest rate charged on that balance is one of the key factors to consider in choosing a credit card. Experts suggest that a low, fixed-rate credit card is better than a low, variable-rate credit card. Card companies can raise their fixed-rate cards when interest rates go higher, but they need to give you notice. With a variable-rate card, your rate can move regularly and without any prior notification.

It is also critical not to miss payments on a credit card, even if you are only paying the minimum. If no payment is made within 30 days of the payment due date, credit card companies may report that to the credit bureaus.

When choosing a credit card, remember to pay attention to the annual percentage rate (APR), annual fee, grace period, penalties, late payment charges, over-the-limit fees, interest rates on any cash advances, and under what circumstances the card company can change your interest rate.

Credit scores

A credit score is a number calculated based on your credit history. This number helps lenders identify how much risk they may be taking in lending you money and your odds of successful repayment. In addition to banks and lenders, landlords, merchants, employers and insurance companies may use a person’s credit score in their application or approval process.

The credit score most commonly used by lenders is known as a FICO score. Each of the 3 national credit bureaus, Equifax, Experian and TransUnion, has their own version of the FICO score. Some lenders also have their own scoring methods. Using online services like annualcreditreport.com, you can request a free copy of your credit report or your credit score.

How credit scores are determined

The credit scoring system awards points based on information in the credit report. The resulting score is compared to that of other consumers with similar profiles. With this information, lenders assess how likely someone is to repay a loan and make payments on time. A high credit score makes it possible
to get instant credit at places like electronics stores and department stores.

Credit scoring methods may include information such as your income or how long you’ve been at the same job. A credit score can range from 300 to 900, with higher numbers indicating a better score.

Approximately 35% of the score is based on payment history.
Approximately 30% of the score is based on outstanding debt. A good guide is to keep your credit card balances at 25% or less of their credit limits.
Approximately 15% of the score is based on the length of time credit has existed. The longer you’ve had established credit, the better it is for your overall credit score.
Approximately 10% of the score is based on the number of credit inquiries a person has received. Multiple inquiries could indicate that you are taking on a lot of debt. FICO scores only count inquiries from the past year.
The remainder of the score is based on current types of credit you have. The number of loans and available credit from credit cards you have makes a difference.

Increasing your credit score

Since your credit score is based on your current credit report, your score changes every time your credit report changes.

Financial advisors often offer these tips for increasing your credit score:

- Reduce the balances on any open credit cards.
- Pay your bills on time—this will affect your credit score the most.
- Review your credit report and correct any errors you find. Getting rid of inaccurate information can sometimes improve your score dramatically.
- Request a credit increase to maintain your debt-to-credit ratio.
- Don’t close all old accounts—this would unfavorably raise your debt-to-credit ratio.
- Minimize the number of inquiries to your credit report.
- If you are turned down for credit because of your score, review your credit report so you can make improvements.

Disclaimer: This information is provided for informational purposes only and should not be construed as financial or investment advice. Consult a professional regarding your specific situation.

external resources

Free Annual Credit Report
Access free annual credit reports from Experian, Equifax and TransUnion.