Managing Your Debt

UNIT FIVE

LEARNING OBJECTIVES

At the end of this Unit, students should be able to:

- *Distinguish between the terms credit and debt*
- *Explain basic information about the usage of credit cards*
- *Explain credit as a form of debt*

INTRODUCTION

Debt is an important area of financial management which must be understood in order to effectively begin saving. Credit card debt is a common form of debt in Trinidad and Tobago and will be used as a practical example to better understand debt management.

Debt

Ask the class what they understand by the term debt. List the answers on the board.

Basically debt refers to an amount owed to a person or organisation for funds or money borrowed. Debt can be represented as a loan, a bond (will be discussed later on), mortgage or other form stating repayment terms and, if applicable, interest requirements. These different forms all imply intent to pay back an amount owed by a specific date, which is set forth in the repayment terms.

If you borrow money from a friend or family member, you have incurred a debt.

Ask the class what they understand by the financial term credit. Write the comments on the board. Credit is a loan of money from someone with the expectation that the money will be paid back at a later date.

Credit and debt are partially symbiotic in nature however – Explain to students that, you can't have debt without credit, but you can have credit without debt. Ask students to keep this in mind as you move through the lesson.

Interest, is the cost associated with borrowing money. It is the cost tagged to using the loaned money, which is added on to the principal amount borrowed. Interest, is the additional cost that one pays for borrowing money.

For Example: *If you borrow money you pay interest, if you lend money you can earn interest.*
Take a look at this example - You borrow $500 from your brother at 5% interest.
5% interest =5/100 x 500 =$25
$500 + 5% interest ($25) = $525
$525 is what you will owe your brother. Your bother earns $25 in interest from you for the loan.

The most common use of credit is via credit cards. Credit cards are cards commonly issued by financial institutions.

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Point out to students that there are other types of debt.

Credit card debt is not the only kind of debt people incur. Individuals also take out participant/member loans for e.g. if aligned with a credit union, mortgages (for a home), car loans, student loans, personal loans from friends or relatives etc.

Credit Card Terminology

Annual Fee – An amount charged to a credit card holder by some creditors to maintain an account. Annual fees are charged regardless of whether a credit card is used or not.

Credit Limit –The amount of credit you are authorised to use.

Interest Rate – The percentage charge applied to your credit balance each month.

Grace period – The period of time from the billing date of your last credit card bill to the due date of your current bill, which is when you can pay in full without being charged interest

Late payment fee – A charge applied to an outstanding balance on a credit card if a required payment is not received by a specific date or received after the grace period.

Minimum Monthly payment – The smallest amount or balance that must be paid before the due date.

Cash advance fee – the percentage charged for withdrawing money in advance from the credit card.

Over-the-limit Fees – A charge imposed on some credit accounts for spending more than your credit limit

Advantages and Disadvantages of Credit

Using credit can have its advantages and disadvantages. Explain to students that if they spend within their means and pay off their balance on time and in full each month, credit cards can serve as a safe, convenient substitute for cash — with the added bonus that they can help establish and maintain a solid credit history.

But if they use them to purchase items they could not otherwise afford — or "max" out their cards to cover routine monthly expenses — credit cards can quickly compound their debt.

The Truth about Credit Cards

Credit cards are issued by financial institutions who must be registered with the Central Bank of Trinidad and Tobago. Many credit cards incur interest rates that run as high as 18 percent annually — which can add up quickly if the balance is not paid in full before the next month.

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Consistently carrying over your balance can result in you incurring more cost charges over time, based on your outstanding loan payment. If you owe money on your credit card/s, the wisest thing you can do is to pay off the balance in full as quickly as possible. Otherwise, money that could be going into an interest-bearing savings account is going to pay interest instead.

Explain to students that an individual is allowed to pay a minimum on the credit card, but paying only the minimum balance due each month, can land the person in a cycle of debt. It can take several years to pay off their credit card by only making the minimum monthly payment.

Demonstrate this example on the board. *For example, say you owe $4,000 on your credit card. The interest rate is 20%. If your minimum monthly payment is $200 – or 5% – it will take you about 2 years to get out of debt. Assuming that you do not make any further purchases to increase your debt, you'll end up spending about $800 in interest.*

Principal =$4000
Monthly Payment = $200
Interest Rate - $4000 x .20 (20%) = 800
Total amount=$4800
Time = 4800 ÷ 200=24 months (2 years)

Key Points

- Pay the balance in full each month.
- Don't make only the minimum payment.
- If you can't pay your full credit card charges each month, the best thing is to pay a fixed amount. The second option, upon receipt of your billed statement, is to pay the minimum monthly payment on the bill, plus an additional amount
- A good rule of thumb would be to pay your charges a few days before the due date – to avoid missing the due date should it fall on a weekend or on a public holiday.

Explain to students that when an individual signs up for a credit card, he/she agrees to certain charges, terms and conditions. There are also rules about what credit card companies can and can't do, and about the information they must include on their monthly statement. Before deciding to own a credit card, remember to conduct the relevant research.

Point out: There is a wide range of credit cards available, all with different features, rewards and fees. Explain to students that they need to:

- Choose carefully so that they get the credit card that best suits their needs and
- Plan on how they intend to effectively use the card

Point out: The interest rate isn't the only thing they need to check out; they also need to find out what kind of fees they will have to pay to use the card.

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Remind students that when they pay for something with a credit card, they are taking out a loan and they have to eventually pay it back.

ACTIVITY

Refer students to Unit Five, Activity 5.1 in the Workbook.

Positive Debt

Remind students that when they take out a loan, they automatically owe that money and thus will be in debt. Indicate to students that they may all accumulate debt at some point in their lives. Especially when they consider the two greatest costs that they may face–funding education and buying a home.

As such debt is not a complete negative and if used wisely can be a great asset. First, let's consider why we should or should not use debt. As mentioned earlier using debt to fund your education or purchase a home (a mortgage) is always recommended. The reason it is recommended is because both of these expenditures are actually investments. Hopefully, what you invest in your education will reap benefits later in terms of higher salary and increased job prospects. Buying a house or land is usually one of the most stable and beneficial investments you can make, considering that real estate tends to appreciate in value. Therefore, these two investments are the first two to consider when acquiring positive debt.

Highlight the word ***(investments)*** as this will be used more often in the next Unit.

Negative Debt

Negative debt is any debt used to buy short-term consumer goods such as clothing, entertainment, electronics, etc. All of these items have a very short life span and usually have no added value when we decide to sell them. Therefore the money we spend on them is really money that we can never get back.

Ask the class what else do we take out loans for? The purchase of a vehicle is another reason that many people may accumulate debt. Though the value of cars tends to depreciate over time, their purchase is also something that most people cannot readily afford to pay for in cash. Therefore this is a debt that most of us have to incur. It does help to take a look at the resale value of the car you are looking to buy, to determine how much money you are likely to get back when you decide to sell the vehicle. This can be the difference between a poor investment and one that allows you to recoup some of your spent money.

One important aspect of debt that most people neglect is simple record keeping. Before taking out a debt, one should determine how much they can pay in instalments. You should have a file created in which you keep careful track of all debt you accumulate along with a payoff plan. If you can simply do this, you will have more control over your debt than the average consumer. Record keeping is the first step towards controlling your finances and it applies to debt, as well as it does to investments.

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Tips for managing debt

- Shop around. Compare interest rates. Don't accept your first offer.
- Keep within your budget in terms of paying instalments – ensure that disposable income is sufficient to meet debt requirements and that there is still some leftover for your other expenses.
- Borrow only what you can afford to pay back regularly and on time.
- Pay back more and pay more often.
- Additional payments mean you'll pay it off sooner and pay less interest in the long run.

Reflection and Summary

Have students individually or in groups:

Write the three most important things they learned about credit cards and debt.

Review the items which students listed with the class. Points should include:

- Credit cards are issued by financial institutions who must be registered with the CBTT.
- Credit cards should be used once the user can pay off all credit at the end of the month
- Paying off your credit card in full at the end of each month is necessary to avoid incurring interest payments. The key to managing debt is to ensure you make your payments regularly and on time.
- Conduct your research on your credit card options – fees, charges etc. before opting to get one
- One can have positive debt or negative debt.
- Borrow only what you can afford to pay back

ACTIVITY *Refer students to Unit Five, Activity 5.2 in the Workbook.*