LESSON FIVE: DEBT

HOW TO STAY OUT OF DEBT

Lesson 5: Debt

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- Students will learn what debt is and how it occurs
- We'll explore when it makes sense to borrow money, and what actions you can take to alleviate debt

Debt - and How to Avoid Getting Buried In It

When young adults borrow money from a friend or relative to buy the latest gadget or fad, the thought of returning the payment often comes second to the initial gratification of buying the item. Long before having to pay back what was borrowed, they may have already moved on to the next thing and forgotten that they still need to pay for their purchase. As they move onto college and adult life, their attitudes around borrowing and returning will likely influence how they approach credit.

Let's explore how credit can open doors if used wisely, but also lead to unmanageable debt if used thoughtlessly.

First, we must know the differences between wants and needs so that we can manage our money responsibly and avoid falling into debt. We all know that certain things like food, shelter, and basic clothing are needs. Video games, concert tickets, and designer sunglasses are wants. Sometimes it can be hard to determine if you really need something vs. just really want it. For example, new designer jeans are great, but do you really NEED to spend $150 on one pair of pants? Let's also assume that you need to have a cell phone because you have a part time job that keeps you working late and mom and dad want you to be safe in case you get a flat tire while driving home. That's a need – BUT having the latest iPhone when your older version works just fine, is a want.

How Debt Happens:

How do people get into debt? There can be many different scenarios, but the most basic explanation is that debt is when you owe more money than you have. The easiest way to get into debt is to make impulsive decisions with money, whether for a want or a need.

So how can you avoid getting into debt. Try asking yourself these three questions before making any spending decision:

1. Can I afford it?
2. How will I pay for it?
3. What will the consequences of my purchase be?

How Debt Happens: (cont.)

What are some examples where you might have to ask yourself these questions? Here's an example that comes to mind. You have a car payment due next week, but you broke your designer sunglasses and you just have to replace them. You know you can't afford both, but how can you drive without your sunglasses - right? So now what do you do? What effect will not paying your car payment on time have?

Now, assume you have a credit card and purchased your sunglasses on the credit card versus using the money set aside for your car payment. Impulsive financial decisions, like using credit to buy wants, can lead to bad debt.

On a side note, there is such a thing as good debt. Good debt is when credit is used to purchase something that is needed, but may be difficult to pay for in cash. It may include items such as financing college tuition or taking out a mortgage to buy a home. Good debt can help build your credit history and demonstrate to lenders that you are financially responsible. This helps show your "credit-worthiness."

Making wise and thoughtful choices with your money can help you maximize savings, build credit and minimize bad debt. Learning how to manage money responsibly is an important part of avoiding debt.

The Snowball Effect:

There are short and long-term effects of debt. For students, debt can snowball very easily if you spend more than you have and only pay the minimum amount due on your bills. There are consequences for falling into debt, such as increased interest payments that can cause you to fall even deeper into debt. Debt also impacts your credit score and, while good debt builds a positive credit history, bad debt can negatively impact your credit score.

How do you think your life would be impacted if you had significant "bad debt?" For example, how would it affect spending time with friends, paying for a new car or planning for college? How might your credit scores be affected? Not handling credit responsibly can have long-term consequences, from decreasing credit scores, to continual calls from creditors seeking payments. If a person gets so deep into debt that they are unable to get out on their own, they may consider filing for bankruptcy as a last resort. While bankruptcy can help eliminate or reduce money that is owed, it damages a credit score and can prevent you from being able to buy a house, open new credit card accounts or obtain any kind of loan.

How Bad Debt Can Be Alleviated:

What would you do if you were in debt? Would you change your spending habits? Bad debt should be avoided because once bad debt snowballs, it becomes increasingly difficult to pay off. If debt gets out of control, there are options such as debt counselors who help develop a plan for paying back money owed, and debt consolidation, which can simplify repayments and lower interest rates. Debt can have a serious impact on credit scores and severely limit opportunities, such as the ability to go to college, afford a new apartment or even purchase a gift for a friend's birthday. The media today has a HUGE impact on society's spending - many images we see encourage us to buy even if we can't really afford it. Making a budget and cutting unnecessary expenses are not only ways to alleviate debt, but also ways to save for the things we want to buy.

DEBT ACTIVITY

Review the credit scenarios below and determine the positive and negative impacts each decision may have on the person's financial future.

Scenario 1

Mark and Ryan just moved into their first apartment together and they want to buy a flat screen TV for the living room. They both work but between college tuition, books and rent their funds are running low. Mark decides to take advantage of a financing offer from a local electronics store and buys the TV on a line of credit. Is this a good or bad debt move? Why?

Scenario 2

Blake just graduated college and accepted a new job as a graphic designer for a marketing firm. He wants to buy a $100,000 condo near his new job and he has saved enough money for a 20% down payment. He is planning on taking out a mortgage for $80,000 to purchase the property. Is this a good or bad debt move? Why?

Scenario 3

Nora has heard that opening a lot of credit card accounts is a good way to build credit. She currently has five credit cards, but is sometimes forgetful in paying her bills on time and usually has a balance on each card. Her favorite store is offering a $50 coupon on her next purchase, with the promise of more coupons in the future, if she opens a credit card. She decides to open the store credit card to get the discounts. Is this a good or bad debt move? Why?

Scenario 4

Alex has collected comic books for years. He regularly attends conventions and trade shows and is knowledgeable about the books' value on the open market. At the latest show, a dealer that he knows well showed him a particularly rare edition that is in mint condition. The dealer has offered him a fair price, and Alex expects the value to increase steadily over the next several years. Alex does not have the money right now, but if he charges the purchase, he can pay off the balance in three months and pay less than $5.00 in finance charges. Is this a good or bad debt move? Why?