

(From *Chapter One: How Credit Works*)

Credit Traps

For many people, reestablishing good credit is the easy part; the hard part is keeping it! If you want to protect your credit, it is essential that you learn to avoid costly credit mistakes, also known as “credit traps.” The following are some of the most common traps:

Using credit cards to buy more than you can afford

This is the classic mistake that people make when they get credit. Instead of using credit cards for emergencies or for convenience, they use them to charge luxuries that they otherwise couldn't afford. They soon find themselves deeply in debt, which makes it difficult or impossible for them to get approved for other types of credit, such as mortgages or car loans. They also end up paying much more in interest than the items were actually worth.

Making only the minimum payment

Although making only the minimum payment probably will not damage your credit record, it will do very little to get you out of debt. In general, the minimum payment only covers the interest for that month; the principle is not reduced at all. Therefore, you'll still owe just as much as you did before.

Having too many credit cards

Getting a major credit card is one of the best ways to re-establish credit. It's even a good idea to have a few of them, as long as you consistently make your payments on time. However, having an excessive number of credit cards can actually cause you to be turned down for loans and other financing. (This is true even if you don't use all of the cards, so be sure to close any accounts you're not currently using.)

“No payments ‘til January of next year!” deals

Department stores have become famous for this type of advertisement. Basically, they allow you to finance a high-priced item, take it home now, and not be required to make any payments for a certain period-- usually several months. What they fail to mention is that you'll be charged interest for that period, which can result in you paying much more than the item is worth. Be sure to read the fine print before accepting one of these deals.

Thinking that the interest rate doesn't really matter

An 8.5% interest rate and a 14% interest rate don't sound all that different—a few dollars, you might think. In reality, the difference can add up to a few *thousand* dollars!

Let's assume, for example, that you are taking out a \$15,000 loan to make home improvements, and you plan to pay it back over a term of three years. With an interest rate of 8.5%, your monthly payments will be \$473.51, and you'll pay back a total of \$17,046.47-- the original \$15,000 plus \$2046.47 in interest.

If, on the other hand, your interest rate on the same loan is 14%, your monthly payments will be \$512.66, and you'll pay back a total of \$18,455.92—the original \$15,000 plus \$3,455.92 in interest. Just by raising the interest rate from 8.5% to 14%, you'll pay an extra \$1409.45 on a three-year loan. That's almost \$500 extra per year! Just imagine what that would add up to on a \$50,000 or \$100,000 loan...

Thinking that the term doesn't matter

When you try to buy a car or even a house, lenders will be primarily concerned with how much you can pay per month, not the total amount you want to pay. If you simply tell a car dealer that you can pay \$450 per month, he'll almost certainly try to sell you a car at that payment on a 48-month term. As a result, you'll pay much more in the long run than you would have on a 36-month term. Always be aware of how much you are *really* paying for a car!

As an example, let's assume that you want to finance a car for 36 months with a monthly payment of \$450 and an interest rate of 10%. Assuming you make no down payment, you'll finance a total of \$13,946.06. If, instead, you agree to pay \$450 per month for 48 months, you'll finance a total of \$17,742.67-- a difference of nearly \$4000. And if you were to make the same deal on a 60-month term, you would finance a total of \$21,179.42—a difference of more than \$7000! See Chapter Three for more information in car loans.

Phony credit-building scams

You won't have to look very far to find a business that claims to be able to rebuild your credit virtually overnight. Many of these scams are simply ineffective; the others are downright illegal. There is simply *no way* to legitimately improve your credit that quickly—you'll just be throwing away your money. See Chapter Seven for more information on credit scams.