Debt and Credit

Description

- Credit cards
- Personal finance
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  - Personal Finance Basics
  - Taxes
  - Mortgages + Housing
  - Debt
- Investing
- Brokers

Credit and debt in depth

- Boost your credit score in months
- A quick guide to getting out of debt
- How to negotiate with your credit card lender
- What is APR and how does it work?
- What is a good credit score?
- 8 ways to pay off debt
- Is a perfect credit score possible for you?
- How to reduce your debt
- How to create a budget you'll actually keep

Credit cards are one of the most popular financial products in Canada. When used right, they can help you boost your credit score, rack up lucrative rewards, and get bonuses and benefits no debit card can offer you.

But that's the trick, isn't it? To enjoy credit cards, you have to learn to borrow money responsibly. Whether you're using credit cards, personal loans, or even student loans, borrowing recklessly can leave you in a massive debt hole, and though it's not impossible to get out debt, it'll be a lot harder than getting in it.

At The Motley Fool, we understand the problems and stress that credit cards and debt can create. Our company was founded on helping people build their wealth through smart investing. But that can't (or, at least, shouldn't) start until you've dealt with debt problems.

How much debt should you have?

Ideally, zero.

But we know that's not always possible, especially with a mortgage. What is especially important is to keep high-interest, “bad” debt at, or as close to zero as possible.

At the very least you want to keep your debt-to-income ratio below 35%. To figure out your ratio, multiply your monthly debt payments by 12, then divide by your annual gross income.

How does debt work?

On the surface, debt seems simple. You borrow money from a lender, then pay it back. But beyond that, debt involves some additional factors you should be aware of.

1. Debt has principal and interest
The principal is the amount that you borrowed. The interest is the price you pay to borrow money, and it’s determined by your interest rate. When you make debt payments, you pay back a portion of the principal along with interest.

2. Credit cards have minimum payments
Yes. And they can be a trap. Every month, you pay at least the minimum to avoid late penalties and damage to your credit score. But if you pay only the minimum, you’ll be in debt for a long time. Ideally, you should pay off your credit card balance in full before your billing period ends.

3. Debt affects your credit score
Your credit score is a three-digit number that tells lenders how well you handle debt payments. The less unpaid debt you carry, the fewer payments you’ve missed, the higher your score will be.

How Can You Get Out of Debt?

Confronting mounds and mounds of debt can feel overwhelming, not to mention terrifying. But you can take control. Here are some common debt repayment strategies.

1. Debt Snowball
With the debt snowball, you prioritize paying off debt with the smallest balance, then work your way to bigger debts. Since you pay debt faster in the beginning, you gain momentum (hence “snowball”), helping you muster the confidence to pay off bigger debts.

2. Debt Avalanche
Unlike the debt snowball, the debt avalanche prioritizes debt with the highest interest rate. You may not move as quickly as you would with the debt snowball, but you’ll likely save more money in interest over the long-run.

3. Debt Consolidation
Finally, you could combine all your debts into one, which you then fire all cylinders until it’s paid off. The benefit of a debt consolidation is you can simplify your debt strategy, reduce the likelihood of overlooking a due date, and possibly lock into a lower interest rate. Balance transfer credit cards are one potential way to consolidate debt when you are struggling with credit card debt.

How Can You Use Debt Responsibly?

Some financial gurus claim debt is a slippery slope: once you start, you'll be swimming in unpaid balances in no time. But nothing can be further from the truth. When used responsibly, debt can help you advance your own financial goals, as well as rack up rewards you can get nowhere else. Here's how to use debt like an adult.

1. Budget your expenses
Before the month begins, make a plan for how you'll spend your income. It may seem like a pain, but trust us — guardrails will help you avoid overspending.

2. Don't overcharge credit cards
Swiping plastic for purchases you can't afford is a surefire way to go into debt. Let your budget make the spending decisions, not your emotions.

3. Keep an emergency fund
Having three to six months of emergency expenses set aside will stop you from reaching for loans or credit cards when a major expense pops up.

4. Pay your balance in full
When you only pay the minimums, you rack up interest charges. Pay exactly what you borrow, and you'll pay less over the long-term.

5. Know when to stop
If you're racked up more debt than you can pay, it's time to put the card away. Focus on paying down debt before you accumulate more.

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