The Cliffs Notes on Going Into Debt for Millennials

Wealth Planning

For a generation that will be leaving college with more student loan debt than any before it, the notion that a certain amount of debt can be good may be difficult to grasp. There is a life outside of student loans, and chances are if you want to purchase a car or buy a home, you will not have the funds available to pay cash for these things. This means you will have to finance them, and when it comes to financing debt, it all comes down to your credit score.

Banks need to know you before they will lend to you. And the way that banks get to know you is through your credit score. This score lets them know how you handle debt, how responsible you are, and how much debt you have. The higher your credit score, the better the interest rates and the more credit you will have available. If you took out student loans while you were in college, you already have a credit score.

However, you may need to establish credit before you need student loans. Perhaps you were able to get through college without taking out loans. All is not lost, as there are other options for you. The first would be to apply for a secured credit card. This is a great option, especially if you are in your late teens or early 20s. With secured credit cards, you make a deposit of cash, which becomes your credit limit. For example, if you gave a lender $250 as collateral, then $250 would be your credit limit. Once you close the account, you get this money back. Another option would be to have someone with established credit co-sign a loan for you. Some credit card companies even have special lines of credit for college students. Generally, the more lines of credit (credit cards, auto loans, student loans, etc.) you have, the better. Keep in mind that each time you apply for a credit card or a loan, you will be subject to a credit inquiry. These credit inquiries can potentially lower your overall score if they become excessive. The exception to this is if you are applying for a larger purchase, such as a home, and you plan to compare rates with a few lenders first. As long as these multiple credit inquires happen within a relatively short span of time (such as one to two weeks), the credit bureaus will treat them as a single credit inquiry.

Once you have established some credit for yourself, how do you give yourself the best credit score possible? Your credit score can range from 300 to 850. A score of 620 is typically the minimum you will need to buy a home, and a score of 750 or above is considered excellent. It goes without saying that to raise your score you need to make payments on time. But how much of your credit should you actually be using? With credit cards, the answer is pretty straightforward, and it surprisingly is not 0%. To have the biggest impact on your credit score, you should limit the amount of outstanding debt at around 30% of your credit cards' limits. If you don't like the idea of paying interest every month, you could even make a small purchase every three months and pay it off. The idea is that you need to show lenders that you use credit and know how to do it responsibly. Generally, your total debt-to-income including your mortgage (your total monthly debt payments divided by your monthly gross income) should not exceed 36%. Having a debt-to-income ratio under this amount will allow you to get the best interest rates. For your mortgage payments alone, as a rule of thumb, you do not want these monthly payments to exceed 28% of your monthly gross income.

Now, how can you get the most out of your debt? One of the best ways is to find a credit card that offers a rewards program you like and pay the balance off every month. If you do not carry a balance, you will not pay any interest. This is a great way to earn rewards on your day-to-day purchases. A lot of credit cards will even offer you additional points just for getting one of their cards. And you can either carry a small balance on this card every month to build credit, or you can have an additional credit card (remember the more open lines of credit the better) that you carry this balance on and that offers you additional rewards.

Lastly, don't forget to monitor your credit score for free at a website such as Credit Karma. Your score will update monthly. If you order a credit report from one of the three credit agencies (Experian, TransUnion, Equifax), there will be no negative impact to your credit score for checking.

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