Credit Card Smarts

Consumer Alert!

1-888-995-7856 ALLIANCE Credit Counseling

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"If people knew that the cost of the minimum monthly payment was that they would still be paying for yesterday's trip to the shopping mall for the next 35 years, some people might decide to pay a lot more..."

-Elizabeth Warren, Harvard Law School professor (Quoted in the Frontline & New York Times documentary *The Secret History Of The Credit Card*)

Credit card use in America has reached monumental proportions. At the end of 2006, Americans owed about 900 billion dollars in credit card debt. Many people are unaware of the degree of overspending that credit card usage promotes. Nearly half of card holders make the tragic mistake of paying only the minimum payment. This publication will help you understand plastic money, with it's potential benefits and pitfalls, and to use credit cards smartly.

Plastic Money

Because they're made from plastic and can be used to make purchases in place of cash, credit cards have come to be called "plastic money." Today, there are different types of plastic money. The chart below highlights some key differences.

	Credit Card	Retail Card	T&E Card	Debit Card
A form of borrowing?	Yes	Yes	Yes	No
Spending Limit:	Pre-approved amount	Pre-approved amount	Pre-approved amount	Your current balance
Payment required:	Monthly minimum	Monthly minimum	Monthly in full	Immediate in full
Issued by:	Financial institution, consumer-product company	Retailer (such as a department store or an oil company)	Companies such as American Express, Diners Club, Carte Blanche	Financial institution
Acceptance:	Accepted widely	Accepted only by that retailer	Less widely accepted	Accepted widely

Notice that a T&E Card (Travel and Entertainment) must be paid in full each month. A Debit/Check Card is merely a means of electronically accessing the funds currently in your checking account, so it's not a form of credit.

Visa and Mastercard are not the lenders or credit providers. They provide a technology and service network for electronic transactions (and advertising), for which they charge the lender or retailer a fee.

Some credit cards are secured by collateral - funds or property you promise the lender can take or sell if you default - which means there is more risk for you.

- Secured Credit Cards typically charge an application fee, carry a high interest rate, and require you to make a deposit equal to the credit limit. People frequently use these cards when they have no alternative. Fraud is common in the industry, so use great care in seeking a reputable card issuer. If you obtain one, it would be wise to carry only a small balance, make your payments on time, and continue using the card only until you can qualify for a regular card.
- Many financial institutions issue a credit card for accessing a Personal or Home Equity Line Of Credit. Because these secured lines of credit are only given to people with good credit ratings, the interest rates are typically lower.

Benefits

Using a credit card wisely can offer several benefits (but notice the cautions in red):

- **Convenience**. It's more convenient to use a credit card than to carry cash. However, this reasoning is only justified if the full balance is paid every month.
- **Protection**. If a credit card is lost/stolen, you can limit your losses. In the event of a disputed purchase or fraud, you may be able to get the charges reversed. In the case of a life-threatening emergency, a credit card may provide the quickest way to obtain certain services. But using a credit card as a safety net is very risky; a smart safety net is an emergency fund created with savings.
- **Record-keeping assistance**. Credit card statements can help you track and analyze your spending.
- **Identification**. Many hotel reservations or automobile rentals require a credit card for the deposit.
- **Credit-building assistance**. One way to help build or raise your credit score is to make consistent on-time payments.

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A credit card account is one way to do that. For more ways to build credit, see the last section below.

• **Debt consolidation**. In rare circumstances, it may make sense to pay off several higher interest loans with a low interest rate credit card. However, extreme caution is needed as this is often attempted with disastrous results. Many people feel a false sense of security after the consolidation and continue the problematic spending patterns. In a matter of months, they find themselves even deeper in debt.

• **Possible Perks**. Some cards offer various rewards or perks, such as air miles or X% cash back on certain purchases. These cards typically carry higher interest rates and use more costly balance computation methods. Considerable effort is required to match a card to your spending patterns and any benefit will be effectively lost if you carry a balance.

Pitfalls

Using a credit card can also have several dangers:

• **Overspending**. Credit card usage promotes overspending by an average of 32% over using cash.

• **Expensive**. Credit cards can be outrageously expensive. Interest rates on credit cards can quickly rise to 30% or more. Monthly late and over-limit charges can range from $20 to $40 or more. These costs can combine to cause debts to "snowball" out of control or take several years to pay off.

• **Identity Theft potential**. Credit cards provide a common means for identity theft. To learn more about reducing this risk, see the last section below.

• **Credit damage**. Poor payment history on a credit card account will negatively affect your credit rating.

Costly Terms

The credit card agreement contains information that you need to know about its terms. Unfortunately, the size of the print and the language used do not make it easy to read or understand. Common terms which affect the cost of credit are:

Finance charge. The finance charge includes the interest rate and any other required charges. The federal *Truth In Lending Act* requires that lenders tell you the finance charge in dollars and as an Annual Percentage Rate (APR). The APR represents the periodic interest rate together with any required charges as a yearly rate. It provides the most accurate way of comparing the cost among credit offers.

Interest rates can be fixed or variable.

- A "Fixed" rate on a credit card only means the rate won't change without at least 15 days notice or unless you violate any one of many conditions.
- A "Variable" rate on a credit card means the rate can increase or decrease without notice.

Fees. Credit card issuers are continuously inventing new fee structures because of the tremendous profits they provide. The most common fees are:

• **Annual fee** - charged yearly, just for having the card.

• **Balance transfer fee** - charged for moving balances from one card to another.

• **Cash advance fee** - charged for accessing cash through an ATM.

• **Late fee** - charged if the payment is not received by the due date (typically $29-39).

• **Over-the-limit fee** - charged if your outstanding balance exceeds your credit limit (typically $20-35).

Grace period. The Grace Period is the number of days you have to pay the creditor before they start charging interest. A typical grace period is 20 days from the date of the statement. Remember that most grace periods are only in effect if you paid the previous month's balance in full and on time.

Balance Computation Method. The balance computation method used determines how your interest is calculated.

• **Average Daily Balance**. Interest is charged on the previous balance, less any payments received. This is the most common method. More expensive variations on this method are to include new charges, possibly with no grace period.

• **Two-cycle Average Daily Balance**. Interest is charged on the current balance plus the previous balance. This is the most expensive method as it results in DOUBLE charges!

• Other less common methods include Previous Balance and the Adjusted Balance.

Gotchas: There are many more terms to be aware of such as "universal default." This means that if you're late with a payment to any creditor or if your credit score drops for any reason, your rate will go up.

Smart Seven

A credit card is not a necessity. Don't believe the media advertisements - it is possible to live a good life without a credit card. If you decide to use a credit card, here are seven smart tips:

1. Before you try to get/use a credit card, establish an **emergency savings fund** of at least $1000 (preferably an amount equal to three months of your living expenses).
2. Before applying for a credit card, obtain a copy of your **credit reports** and address any issues or errors. For assistance, read our publications in the last section below.
3. **Shop** for a card with terms that will give you the most benefit for your spending patterns. There are websites that can help you compare credit card offers, such as: www.bankrate.com, or www.cardweb.com. But keep in mind that the terms can change at any time.
4. **Limit** your number of cards (more than one or two is rarely wise).
5. Be a **convenience user**. Limit your card use; only use a credit card when a debit card cannot provide the same benefits and never charge more than you know you can pay in full each month.
6. Know your **rights**. Federal laws, such as the *Fair Credit Billing Act*, require lenders to correct billing errors promptly. To learn more about your rights and how to dispute charges, read *Fair Credit Billing* and *Billed For Merchandise You Never Received?* at www.ftc.gov/bcp/menus/consumer/credit/loans.shtm.
7. **Support** credit card reform legislation to make credit card terms fair. For more information, read *The Plastic Safety Net* at www.responsiblelending.org.

To Find Out More

➢ For a free annual copy of your credit reports visit www.annualcreditreport.com or call 1-877-322-8228.

➢ Read the following articles available at *our website* www.knowdebt.org/education.php:

- *Building Good Credit*
- *How To Check Your Credit Reports*
- *How To Dispute Errors On Your Credit Reports*
- *Identity Theft: What You Don't Know Can Hurt You*