BalanceTrack®
A DIVISION OF BALANCE

Credit Matters

In today's world, credit does indeed matter. In fact, obtaining and using different types of credit instruments is part of almost every American's financial life. However, because it is so easy to make expensive mistakes that can follow you for a long time, it is a good idea to learn how to borrow wisely from the beginning. This program will cover the core concepts of credit usage, including:

- What is Credit?
- Getting Started
- Using Credit to Your Advantage
- Delete Your Debt
- Consumer Rights and Responsibilities

Chapter 1: What is Credit?

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In the broadest sense, credit means having the use of something before you pay for it. It adds flexibility to planning and makes it possible to pay for expensive items over a period of time. Credit comes in many different forms and it is important to understand how each works so you can obtain the right type for your needs.

Secured Credit
This is commonly used to purchase a large item such as a home, car, or appliance. An asset (most often the item purchased) called collateral secures the loan. If you do not keep the monthly payment arrangement, the creditor has the right to reclaim the collateral. There are two types of secured credit:

- Secured/Closed-end. With a secured/closed-end credit instrument, you put down an initial deposit, and the item you purchase is taken as collateral for the loan. The remaining balance is calculated into equal installments that you repay over a specific period of time. An example would be a car or boat loan.

- Secured/Open-end. Secured/open-end credit is usually a type of revolving credit that is secured by collateral that you put down to secure the loan. It can be repaid in a single payment, equal payments, or unequal payments. A home equity line of credit is an example of secured, open-end credit.

Unsecured Credit
This is credit extended without collateral (security). Because of the higher risk to lenders, unsecured credit generally carries a higher interest rate than secured credit.

- Unsecured/Closed-End. Sometimes referred to as signature loans or personal loans, the repayment is made in equal, monthly installments. An example is a debt consolidation loan.

- Unsecured/Open-End. The lender sets a credit limit and the borrower may use up to that amount. The initial agreement states the terms of repayment and the credit limit. Bills are issued monthly and the minimum payment due is based on the balance and terms. Credit cards are the most common form.

Credit Cards
There are several types of credit cards on the market:

- General-purpose credit cards can be used virtually anywhere.
  - If you have both an excellent credit history and a high income, you may be offered a "premium" card (sometimes called Gold or Platinum), which comes with a high credit limit and enhanced customer service.
  - Some credit cards offer points, rebates, or cash-back rewards where the more you use them, the more benefits you receive.
- Retail cards may only be used at a particular retail establishment, such as a department store or gas station.
- Small business cards offer special perks to business owners and their employees.
- Student cards generally offer lower credit limits and special benefits for students.

Charge cards
A charge card is similar to a credit card, but you have to pay the entire balance in full each month. The credit limit is often very high or even unlimited. Charge cards usually come with higher annual fees than credit cards because no interest is charged. If you cannot make a full payment, a high rate of interest is assessed and late fees are charged. Collection action can be swift and severe.

Debit Cards
It is important to not confuse debit cards and credit cards. Because the money is deducted from your checking account right away when you use a debit card, it is not a type of credit.

Chapter 2: Getting Started

What You Should Look For
Before you apply for credit, make sure you know what the terms of borrowing are, especially the following:

- **Annual percentage rate (APR)** – The APR is the annual rate of interest charged on the outstanding balance. The lower it is, the lower the cost of borrowing. The APR can either be fixed, meaning it never changes, or variable, meaning it fluctuates according to an index. For credit cards, a variable rate is common, as is charging a different rate for different types of transactions. (For example, the APR for cash advances is usually higher than the APR for purchases.) For mortgages and other large loans, a fixed rate is usually preferable because the payment is set. You may be able to get a lower rate initially with an adjustable-rate loan, but if the interest rate rises, the payment does too.

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Keep in mind that the rate advertised in the application or marketing materials is the rate that is given to borrowers with the strongest credit history. After the creditor processes your application and checks your credit score, you may be given a higher rate. If you are not satisfied, you do not have to take the credit.

- **Grace period** – For credit cards, a grace period is the number of days, usually 21 to 30, before interest is assessed on new purchases. (It is only given if you paid off your balance in full the previous month. Also, there is usually no grace period for cash advances.) If your credit is good, you should have no problem finding a card with a grace period.

- **Annual fee** – Unless you want special features, if you have good credit, you should be able to find a credit card that does not charge an annual fee. If you have no or a poor credit history, you may be out of luck. However, once you build a positive credit history, request that the fee be reduced or eliminated, or shop for a card that doesn't charge one.

- **Late fee** – Virtually every credit issuer charges a late fee. You should always make your payments on time, but it does not hurt to look for an account with a low late fee just in case.

- **Application or activation fee** – For secured loans, you may have to pay an application fee (which should be refunded if you are denied). However, if you have good credit, you should not have to pay one when applying for a credit card. Neither should you have to pay a fee to activate the card.

- **Miscellaneous fees** – Some credit card issuers charge for a variety of other activities, such as for not carrying a balance or carrying a balance under a certain sum. The better your credit history is, the less you have to accept such expensive terms.

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What Creditors Look For
To get a credit card or other type of credit, you must fill out and submit an application. You may receive a "pre-approved" offer in the mail, but it is just a marketing device – you still have to apply.

While specific approval guidelines vary from lender to lender, many base them on the "Five C's of credit":

- **Character** – Character refers to how responsible you are with repaying your debts. Most creditors judge this by looking at your credit report and/or score. Your credit report tracks your credit activity: what accounts you have, how much you owe, your payment history, etc. Your credit score is a numeric summary of the information in your credit report and is formulated to predict the likelihood you will not repay what you borrowed. The two most important factors in your credit score are your payment history and level of debt (the higher the balance, the lower your score, especially if the balance is close to your credit limit).

- **Capacity** – Capacity refers to the ability to repay what you borrow. Few lenders would approve you for a loan with a $1,700 monthly payment when you are bringing in $1,800 a month. Creditors also usually consider what your current debt obligations are. If a creditor feels you do not have the capacity to pay back the amount you want to borrow, they may deny you or approve you for a lesser amount.

- **Capital** – Capital refers to the assets that you have. Basically, the creditor wants to know if you have savings or other assets that you can use to make your payments if you lose your job or experience something else unexpected.

- **Collateral** – When you are applying for secured credit and the collateral is an item, not cash, the lender will likely be concerned with what the condition of the collateral is. For example, most lenders require an appraisal when you apply for a mortgage. A crumbling house near a toxic dump that appraises for $25,000 is not very good collateral for a $200,000 loan.

- **Conditions** – Conditions are situations that could affect your ability to make payments. Often these situations are beyond your control. For example, a creditor may be less likely to lend to people if the economy is weak and many companies are shutting down.

New to Credit
If you are new to credit (or trying to reestablish a positive credit history), you may find it difficult to get approved for a regular credit card or loan. However, you still have options. A secured credit card is usually the easiest type of credit to get. As mentioned previously, it requires you to make a cash deposit that the creditor can keep if you do not make your payments. (You will get the deposit back otherwise.) The credit limit is often low, and the fees can be high, but you may be able to convert it to a regular credit card after a year or two of on-time payments. Make sure that the creditor reports your account to the credit bureaus – if they don't, you won't be establishing a credit history. The approval standards are often not that strict on retail cards either. Another option is to have someone with a good credit score cosign an account for you. This requires a great deal of trust on the part of the cosigner – if you fail to pay, he or she can be held responsible for the full balance.

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Chapter 3: Use Credit to Your Advantage

Credit use is not without its pitfalls. Interest rates and fees can dramatically increase the cost of a purchase made on credit, and generous credit lines make overspending easy. However, when used correctly, credit can be an excellent tool, and it's the only way to build a positive credit history – which will help you get what you want in the future at the lowest cost.

Wise Use – and Misuse
There are many appropriate uses for credit cards. Because of the protections provided and fact that the money is not immediately deducted from your checking account, it is a good payment option for on-line purchases, airline tickets, car rentals, hotel rooms, and other products and services that require advance payment. Furthermore, it makes it easier to track your spending since you receive detailed account statements. With some cards, you can even accumulate points for such goodies as airline tickets, cash back rewards, and discounted merchandise. Best of all, if your card has a grace period and you pay off your balance in full each month, you get all of these benefits without having to pay any interest.

Many people get into trouble when they see their credit line as "extra cash." It is not a bonus for vacations or money for emergencies (that is what savings is for). Most importantly, it is not additional income to get you through a shortfall until the next month. Using it that way may help temporarily, but it will make the next month more stressful when the same cash flow problems arise – but with more debt to pay.

It is best to use close-ended credit for something that will provide a long-term benefit. For example, taking out a mortgage to buy a home provides your family with a place to live and can also be an investment because most homes increase in value over time. However, even if it will provide a benefit, it is important to make sure that you can comfortably afford the monthly payment before you borrow. Don't just rely on the lender's approval amount – take a look at your budget to see how much money you have available to make payments. Remember, once you sign the loan papers, you are legally obligated to pay the loan back under the set terms.

Tips

- Only charge the amount you can afford to repay when the bill comes due.
- Know your due dates, and always pay on time. Late payments can be reflected on your credit report and lower your score.
- If you have debt now, repay it as quickly as possible.
- Avoid expensive, high-penalty loans that that can work against you.
- Keep your charge receipts in an envelope with a running total on the outside. If the total exceeds an amount you consider appropriate, curtail your spending.
- Avoid shopping in stores where you know you will be tempted to spend more than you can afford to repay.
- Save monthly for such periodic and emergency expenses as vehicle maintenance, medical bills, holiday gifts, and vacations. That way, you won't need to use credit to cover these expenses, or, if you do charge them, you can pay the balance in full when the bill arrives.
- Limit the number of open credit card accounts you have. It's much easier to keep track of your total outstanding debt with just a couple of accounts.
- If you are having a hard time using credit responsibility, it may be best to not have any active accounts until you can make changes, even if it hurts your credit score.

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Credit To Avoid
Not all credit is created equal. There are some loans on the market today that are especially costly for consumers and should be avoided:

- **Payday loans** – This is a way to borrow from your future income. You write a check to the lender for the amount you wish to borrow plus a fee. The check is typically held until your next payday, at which time you can either redeem the check by paying the face amount or allow the check to be cashed. If you can't afford to cover the check, you may roll it over for another term by writing another check, which will result in another set of fees being added to the balance. With an average annual interest rate of more than 400 percent, payday loans are no bargain.

- **Car title loans** – Car title loans are promoted as small emergency loans but because the interest rate is often in the triple digits, repayment can be difficult and expensive. You don't need good credit or often even a job to receive a car title loan – just sign over your title as collateral and hand in an extra set of keys. The typical repayment period is one month. Though most loans are for $1000 or less, the finance charges quickly rack up, and it is possible to lose your vehicle if you can't meet the payments.

- **Pawn shop loans** – You take a consumer good, such as an electronic device or jewelry, to the pawn shop and are given a short-term loan in exchange for leaving the item there as collateral. If you pay back the loan, including interest, on time, you get the item back. However, if you fail to repay or renew the loan, your item can be sold. The APR for pawn shop loans are typically

around 120-300 percent, much higher than the rate charged on credit cards. Many pawn shops also charge additional fees for insurance and storage.

Chapter 4: Delete Your Debt

If you currently owe money on credit cards and/or personal loans, it is a good idea to develop a plan to repay them as quickly as possible. Finance charges make holding onto balances extremely expensive. There are several methods you may be able to use to delete your debt efficiently.

Pay Extra

Are you just making the minimum required payments now? Minimum payments are often set very low, and you may be able shave years off your debt repayment time just by paying extra. If you have multiple accounts, it is better to be systematic and focus your extra payments on one creditor at a time instead of sending a little extra to all of your creditors. (Of course, you should continue to make minimum payments to everyone.) Many people like to start with the debt with the lowest balance because it will be paid off the soonest, providing gratification that makes it easier to keep going. However, you will save the most money by starting with the debt with the highest interest rate. Once the first debt is paid off, put that money toward the debt with next lowest balance or highest interest rate and so and so on until all of the debts are paid off.

If you feel that you currently don't have any spare cash lying around, take a close look at your budget. Are there any expenses that can be cut or reduced, like dining out or cable? Do you receive periodic sources of income, such as a tax refund or bonus, that you can direct toward your debt even if you can't afford to pay extra on a regular basis?

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Balance Transfer

As the name implies, a balance transfer is the transfer of the balance from one credit card (or another type of debt) to another. This could be a good option if you are able to get a card with a lower APR than what you have now. The lower your interest rate, the more of your payment that goes toward principal and the sooner you will be debt free. However, before you do a balance transfer, be aware that most creditors charge a balance transfer fee. If the interest rate on the new card is only slightly lower, the savings may be negligible.

It is better for your credit score to keep old accounts open when you do a balance transfer. However, make sure to use them responsibly. If you charge them up and cannot pay off the balances in full each month, you could wind up with more debt than before.

Home Equity

If you are a homeowner and have equity in your home (owe less on your mortgage(s) than the home's value), you may be able to use some of that equity to pay off your unsecured debt. Not only is the interest rate on a mortgage usually lower than for unsecured debt, but, in most cases, the interest paid is tax-deductible as well. Besides selling, there are two basic ways you can take the equity out of your house:

- **Cash-out refinance** – With a cash-out refinance, you take out a new mortgage for an amount greater than the balance on your existing mortgage and get back the difference in cash. For example, you owe $240,000 on your mortgage and refinance with a $260,000 mortgage – you

receive $20,000, which you could use to pay off your debt. Keep in mind that you typically need to have good credit to refinance, and there is a limit as to how much equity you can take out. (Doing a traditional refinance is another option. You won't receive any cash to pay off debts, but if you can lower your mortgage payment, you will have more money to send to your other creditors each month.)

- **Second mortgage** – A second mortgage is a loan or line of credit that is taken out against your home in addition to the first (or primary) mortgage. If you take out a home equity loan, you receive a lump sum at closing. If you opt for the home equity line of credit, you can withdraw from it repeatedly over a set period of time. Like with refinancing, you usually need to have good credit to be approved, and there is a limit as to how much you can borrow.

Think carefully before you decide to refinance or take out a second mortgage to pay off debt. Both options come with fees that can cancel out your potential savings. Furthermore, if you are spending more than you make, tapping out the equity in your home to pay off consumer debt is a short-term solution that can put your home in jeopardy of foreclosure. Many people get into trouble by using their home equity to pay off unsecured debts, then running up the credit cards again. That pattern leads to a very difficult situation: no home equity, high debt, and the inability to make payments on both secured and unsecured financial commitments.

Debt Consolidation Loan
Another possibility you may have is consolidating some or all of your debt into a new loan. Many financial institutions offer unsecured loans specifically for debt consolidation. The advantage is that you have one convenient payment, and if your credit standing is good, you may be able to get an interest rate that is less than what you currently have. However, if it isn't, be prepared to pay more.

Like with a balance transfer, cash-out refinance, or second mortgage, if your expenses exceed your income and you need credit to close the gap, a debt consolidation loan is just a short-term solution that may not benefit you in the long run.

Debt Management Plan (DMP)
DMPs are administered by credit counseling agencies. You make one payment to them, and they distribute the money to your creditors. For people with multiple accounts, being able to make one payment can be a relief. Furthermore, many creditors reduce or even eliminate interest rates and fees for borrowers on a DMP, so less money goes toward finance charges and more goes toward the principal. Because you are required to suspend further use of your credit lines when on the plan, there is not the risk of getting further into debt like there is when taking out a loan. In order to participate in a DMP, you must first complete an hour-long session with a counselor, who will examine your financial situation and see if it is an affordable and beneficial option.

Chapter 5: Consumer Rights and Responsibilities

When you use credit, you enter into a contract – the financial institution lends you money with specific terms, and you agree to repay it under those terms. Therefore, as a borrower, you have both rights and responsibilities.

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Federal Law
The Federal Trade Commission (FTC) enforces these rules. Any violation should be reported to the FTC at www.ftc.gov, 202-326-2222.

Truth in Lending Act (TILA)
The TILA requires credit issuers to disclose the following:

- The finance costs in dollars, annual interest rate, and any late or penalty fees that may be imposed.
- Written itemization of the amount borrowed and the total amount of the loan, including interest and fees, and the number, amount, and due dates of all payments necessary to repay the loan.

Fair Credit Billing Act (FCBA)
The FCBA offers the following protections under the law:

- Liability for lost or stolen credit cards is limited to $50 if you notify the card issuer within 30 days.
- If you purchase a defective item or substandard service by credit card, the payment can be withheld if the seller refuses to replace, repair or otherwise correct the problem.
- If there has been an error in a credit card bill the lender must correct it, or explain why the amount is believed correct, within 90 days after being notified.

Fair Debt Collections Practices Act
The FDCPA regulates collection agencies' conduct, and specifically prohibits such action as:

- Calling before 8am or after 9pm, or at any inconvenient time.
- Calling you at work if you have informed the collector that the calls are jeopardizing your job.
- Discussing your debt with a third party other than your spouse without your permission, except to leave a message that he is trying to contact you.
- Using profanity.
- Misrepresenting himself. For example, he cannot say he is an attorney if he is not.
- Collectors cannot make false threats. If a collector says he is going to take a specific action against you to enforce the debt, he has to do it.

Credit Card Accountability Responsibility and Disclosure (Credit CARD) Act
The Credit CARD Act was designed to protect credit cardholders and give them certain rights, including:

- Your interest rate cannot be increased during the first 12 months of opening a credit card unless you are more than 60 days late with a payment.
- An interest rate increase can only apply to new charges, not the pre-existing balance. (This rule does not apply if you are past due more than 60 days.)
- If your interest rate was raised due to making a payment late, the card issuer must reinstate the lower interest rate if you make on-time payments for six months.
- You cannot be charged an over-the-limit fee unless you authorize your credit card company to process over-the-limit transactions.
- If your due date falls on a weekend or holiday, your payment is considered on time if it is made on the next business day.

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Debt and lawsuits
A creditor or collector cannot take any wages, money, or property without first suing you in court, winning, and then obtaining a judgment. Also, be aware that in most instances you cannot go to jail for non-payment of unsecured debt, even if you have lost a lawsuit.

State Law
You may also have additional rights under state law. Check with your state's Office of the Attorney General for more information. To locate your Attorney General, contact the National Association of Attorneys General at www.naag.org.

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