CREDIT CARDS

What You Need To Know

Credit Cards: What You Need to Know

Why learn about credit cards?

Credit cards are an essential part of your financial wellbeing. Even if you don't like the idea of borrowing money to buy something, credit cards have a major effect on your credit score. And your credit score affects your life's big decisions, such as getting a mortgage on a house, taking out an auto loan, and much more.

The more you learn about them, the less likely you are to get taken advantage of by credit card companies that don't have your best interest in mind. This booklet will walk you through the basics of credit cards, what to do about credit card debt, how to avoid credit card debt, and how you're protected as a consumer who uses credit.

Pros & Cons of Using Credit

Advantages:

- Able to buy needed items now
- Reduce a need to carry cash
- Creates a record of purchases

Disadvantages:

- Interest (higher cost of items)
- May require additional fees
- Financial difficulties may arise if one loses track of how much has been spent each month
- Increased risk of impulse buying

Mike's Story: An Over-Cautious Attitude

When I was in college, I didn't think a credit card was necessary. I was already taking out student loans, so I wanted to stay away from any other kind of debt. My debit card and cash were enough for me. But after I graduated, I realized my mistake.

I had to move all the way to Phoenix, Arizona, from a small town in Virginia for a job. All the money I had saved up for a new car had to be used to pay for movers and to put a deposit down on my new apartment in Phoenix. But my car was old, and after the drive to Arizona, it was barely functioning. I had to get a new car as soon as possible, and I knew I would need to finance it.

When I picked a car and asked the dealership about financing, they said they had to run a credit check first. However, since I had never really used any type of credit before and I wasn't paying off my student loans yet, I had no credit history!

After that, it was a struggle to find a legitimate dealership that would let me finance a car with no credit. If I could go back, I would have gotten a credit card earlier and used it responsibly. It would have given me a better credit history and made my move so much easier.

Moral of the Story: Credit cards can be a risk, but when used responsibly, they can also be essential for building your credit profile!

Credit Card Basics

Revolving Credit vs. Charge Cards

With revolving credit, repayment is made at regular time intervals for any amount at or above the minimum required amount. Interest is charged on the remaining balance that carries over. This is how most credit cards work.

A charge card is different because there is no interest charged. However, you must pay your full balance by the due date each month.

Unsecured vs. Secured Credit Cards

An unsecured credit card has no collateral against your purchases. On the other hand, secured credit cards require some sort of security deposit or collateral to secure the line of credit. If you have a low credit score or you're working on building credit, you may need to go for a secured credit card. You will need to put down a small cash deposit to open a secured credit card.

Interest and Fees

APR stands for annual percentage rate, and it determines the interest you are charged on the balance you carry over each month. Let's say you run up $500 on a credit card that charges 15% interest and requires a 2% minimum payment each month. Even if you never charge another item and pay the minimum on your account, it will take 6½ years to repay your debt. When you have finally paid your debt, you will have paid nearly $300 in interest on your $500 purchase, making your total cost nearly $800. In addition to late fees and yearly fees, this can really add up.

Credit Limits

When credit card companies extend a line of credit to you, they also give you a limit. This means you can only spend a certain amount on that credit card. For example, a store card may come with a $1,000 limit. If you spend more than $1,000, you may incur some fees or have your card declined. When you spend your whole credit limit, then the card is "maxed out."

Why are credit limits important? They contribute to your credit utilization ratio, which has a big effect on your credit score. Your credit utilization is calculated by dividing the balances you've charged by the total of all of your credit limits. Anything higher than 30% can damage your credit.

Rewards Cards

Credit cards with rewards programs can be great if you use them correctly. Cash back and travel offers can be tempting, but these cards typically have very high APRs and yearly fees. Don't fall into the trap of charging an excessive amount of purchases on a card simply because you want to rack up the points.

Kirsten's Story: A High Credit Limit for the Holidays

I used to have great credit, and I got a bunch of great offers in the mail that said I was prequalified. I signed up for one, and because of my good score, they gave me a really high credit limit. Great timing, because I had a lot of stuff on my Christmas list that I didn't have the money for.

I spent a lot of money that season and charged it all on my new card. It had a great 0% APR intro offer, so I thought it would be fine to get close to the limit and pay it off over the next year. I spent nearly the whole $5,000 credit limit.

Over the next year, I paid a little more than the minimum required payment and didn't think much more about it. I wasn't paying any interest, so didn't feel rushed to pay it off. At the end of that year, though, I still had $1,500 in debt on that card.

I looked around for some balance transfer card offers. Maybe I could qualify for one of those? I applied to one, but I was quickly denied. I was really confused because I thought my credit score was good enough. Turns out that I had used up so much of my credit limit on that card that my credit utilization ratio was way too high, and my credit score had tanked without me knowing.

Moral of the Story: A credit limit is a limit, not a goal.

How Much Credit Can You Afford?

Never borrow more than 15% of your yearly net income.

Example:

If you earn $500 a month after taxes, then your yearly net income is: 12 x $500 = $6,000

Calculate 15% of your annual net income to find your safe debt load.

$6,000 x 15% = $900. So, you should never have more than $900 of debt outstanding.

Note: Housing debt (i.e. mortgage payments) should not be counted as part of the 15%.

Monthly payments shouldn't exceed 10% of your monthly net income.

Example:

If your take-home pay is $500 a month: $500 x 10% = $50.

Your total monthly debt payments (not including your mortgage) shouldn't total more than $50 per month.

Using Tech for Your Credit Cards

Keep these advancements in mind when shopping around for a credit card or just doing your usual spending.

Venmo

Venmo is an app that you can connect to your bank account or a credit card to make it easier to transfer money among friends. Now, some retail outlets and restaurants are also taking Venmo payments. This app can be great for repaying friends but be wary of using it all time – even though it's on your phone, it's still credit.

Mobile Wallets

Google Pay, Samsung Pay, Android Pay, and Apple Pay are popular mobile wallets. Basically, you can pay for things with your credit cards and debit card from your smartphone.

Contactless Cards

You may have already seen “Tap to Pay” signs in stores. Those are for contactless cards, which are becoming more and more common. These are programmed to make payments without having to insert or swipe the card. And they’re just as safe – if not safer – than regular credit cards.

Preventing Credit Card Debt

With every credit card you get, there is risk attached. Combating that risk is all in your hands. It’s your responsibility to control your spending and ensure you’re living within your means.

Stick to a budget

A budget is the number one way to prevent credit card debt. It ensures that you are living within your means and not spending too much compared to your income.

Pay in Cash

When you use cash for all your purchases, there’s no risk of spending more than you have. A great way to organize your cash is with a cash envelope system, in which you label envelopes for all your expenses and divide the cash from your paycheck into these envelopes to use throughout the month. Once the cash is gone, it’s gone.

Pay off your full bill

A foolproof way to prevent credit card debt is to pay off the full balance on all of your cards every single month. If you can use credit cards this way every month, then interest charges never apply to your balance. You enjoy all the benefits of credit cards without added interest charges. If this isn't possible, pay as much as you can.

Always pay more than the minimum

Never be satisfied with simply making the minimum payment. Minimum payments were designed to keep you in debt, not help you get out of it. If you can't pay the full balance for the month, at least pay as much as you can over the minimum payment. You will thank yourself later.

Save for emergencies

The larger your emergency fund, the less of a chance that you will have to make large charges to cover unexpected costs. Contribute a fixed amount to your savings each month to build up your emergency fund and protect your credit.

Dealing with Credit Card Debt

Whether you overspent or needed to charge more because of an emergency, there are ways to deal with your credit card debt.

Make debt payments a fixed expense

If you have a small amount of credit card debt, setting a monthly debt payment that's higher than the minimum required payment is a great way to hold yourself accountable.

Snowball method

The snowball method starts with paying off the card with the lowest balance. This usually works best for people with either a large volume of debt or limited available cash flow.

Avalanche method

In this method, you start paying off the card with the highest APR first. This works best for people with excess cash flow. It also helps you save money because you pay off the cards that generate the highest interest charges first.

Dianne's Story: Overwhelmed with Credit Card Debt

In 2015, my husband and I got divorced. During our marriage, I had been a stay-at-home mom. I hadn't worked in nearly 10 years. Now I had to cover every expense on my own, and I didn't have any other option besides using credit cards. I tried not to think about how much I was spending, because I knew it was too much. But my kids needed me, and I literally had to buy myself time until I could find a job.

Eventually, I found a job as a secretary at a medical office. The pay wasn't ideal, but it was better than nothing. I finally worked up the courage to check my credit card balances a few months into the job: nearly $8,000. I knew it was bad, but I hadn't imagined it would be this high. I didn't know what to do, and I could barely afford my electric bill on my secretary salary.

Once I calmed down, I started looking into options. I read about this snowball method where you start with the card with the lowest balance. I barely had any cash to spare, but I did my best to pay what I could.

I finally started noticing some progress after about six months. Once I get a job with higher pay, I'll be able to put even more toward my debt and hopefully get rid of it even faster.

Moral of the Story: It's never too late to start recovering from credit card debt.

Balance Transfer Card

A balance transfer card is a credit card that usually has very low or nonexistent interest offered for a limited period of time. You can transfer credit card debt from other cards onto the balance transfer card. This means you only pay one bill and aren't racking up as much interest. However, many cards charge a small fee or a percentage of your balance when you transfer. If you have a very low credit score, you may not qualify for the card.

Debt Management Program (DMP)

A DMP is when you work with a certified credit counselor to repay everything you owe at lower interest rates. You will only have one monthly payment, and it will typically be lower than what you are currently paying. When done correctly, a debt management program won't damage your credit score. The credit counseling agencies that run these programs usually have many free financial education resources that can help you learn better credit habits.

Debt Settlement

If you know you won't be able to pay off your debt and you aren't worried about your credit score taking a big hit, debt settlement could be a good relief option for you. Basically, you work with a debt settlement company to settle with your creditors for less than what you owe. Then you make one, smaller monthly payment.

Unfortunately, this will majorly hurt your score. This could be a problem if you're trying to get a mortgage or buy a car soon.

How do lenders decide who qualifies for a credit card?

You've likely applied for many credit cards in your lifetime. Sometimes you were accepted, sometimes you were denied. But do you know how the credit card companies decided if you qualified? Lenders and credit card issuers alike use the "Three Cs" to determine creditworthiness:

Character

Will you repay the debt?

- Have you used credit before?

- Do you pay your bills on time?
- Do you have a good credit report?
- Can you provide character references?
- From your credit history, does it look like you possess the honesty and reliability to pay your debts?
- How long have you lived at your present address?

Capacity

Can you repay the debt?

- How long have you been at your present job?
- Do you have a steady job?
- What is your salary?
- How many other loan payments do you have?
- What are your current living expenses?
- What are your current debts?
- How many dependents do you have?

Capital

What if you don't repay the debt?

- What property do you own that can secure the loan?
- Do you have a savings account?
- Do you have investments to use as collateral?

Your Credit Card Rights

Consumer rights protection laws are meant to reduce the problems and confusion surrounding consumer credit, which, as it became more widely used in our economy, also grew more complex. Together, these laws set a standard for how individuals are to be treated in their financial dealings. Here is a summary of the laws:

Fair Credit Reporting Act (1970)

Protects the privacy and accuracy of information in a credit check. Under the federal Fair Credit Reporting Act, credit reporting agencies are not allowed to report any information that is too old, incomplete, or wrong. While positive or neutral information can be reported indefinitely, negative information can only be reported for a certain amount of time. This law also guarantees consumers the right to review their credit report and dispute information that they believe is inaccurate.

Equal Opportunity Act (1974)

Prohibits discrimination in extending credit on the basis of sex, race, color, religion, national origin, marital status, age, or receipt of public assistance. This law applies to any business that grants credit to consumers, including banks, finance companies, retail and department stores, credit card companies, and credit unions.

Fair Credit Billing Act (1974)

Sets up a procedure for the quick correction of mistakes that appear on consumer credit accounts. When you purchase goods or services with a bankcard or a retail store charge card and you discover an error on your account billing statement, you have the right to have the problem resolved through the dispute resolution process established by the federal Fair Credit Billing Act (FCBA). The FCBA applies to such errors as:

- Your account is not properly credited for a payment you made or for a refund you are entitled to.
- Charges that you did not authorize appear on your statement. The law limits your responsibility for these charges to $50.

- You are charged the wrong amount for a purchase.
- There are mathematical errors on your account statement.
- You are billed for goods or services you did not accept or that were never delivered as agreed.
- Your account billing statement arrives late because it was sent to your former address even though you provided the creditor with written notice of your change of address at least 20 days before the end of the period you were billed for.
- Your account statement reflects charges for insurance or for another type of service or product sold by a credit card company, but you did not authorize the charges.

Fair Debt Collection Practices Act (1977)

Prevents abuse by professional debt collectors and applies to anyone employed to collect debts owed to others; does not apply to banks or other businesses collecting their own accounts. Here is a summary of what debt collectors covered by the FDCPA cannot do when they are trying to collect from you:

- Call you at an inconvenient time or place such as before 8AM or after 9PM unless you give them permission to do so.
- Call you at work if they know that your employer does not want you to be called there. Also, they cannot contact your employer about your debt.
- Contact you by postcard or use an envelope that makes it clear that a debt collector sent it.
- Try to scare you into paying a debt by sending you a letter that appears to have come from a government agency or a court of law.
- Call you repeatedly within a short period of time – every hour during an afternoon, or day after day for example.
- Contact your neighbors, relatives, friends, or other people to get information that can help them collect the money that you owe.

- Use profanity when communicating with you.
- Threaten to ruin your reputation, harm you or your property, or throw you in jail unless you pay your debt. However, debt collectors can threaten to sue you assuming they are willing to follow through on their threat.
- Order you to accept their collect calls or pay for their telegrams.
- Collect more than the amount you owe, unless it is allowed under your state's law.
- Deposit a post-dated check before its date.
- Take your property or threaten to take it unless they are legally entitled to.

Credit Card Accountability, Responsibility, and Disclosure Act (2009)

The Credit Card Accountability, Responsibility, and Disclosure Act, or Credit CARD Act, makes it easier for you to deal with the credit card giants. For instance, credit card issuers will be required to show you, on periodic statements, how long it will take to pay off your existing balance and the interest you will accrue, if you pay the minimal amount.

Use this valuable disclosure to get a grip on your spending – be accountable. This is a free educational device showing you, in plain language, what it will take to reduce your credit card balance. If the sirens go off in your head when you look at this information, then you'd better halt your spending and get your finances in order.