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How to Use Credit Wisely

A borrower's guide to financial health covering the basics of surviving the world of credit. It includes:

- Tips on choosing the right credit card.
- The true cost of credit card balances.
- The ins and outs of balance transfers.

Plus updates on consumer protection laws, establishing credit, and avoiding fraud.

Polina Vlasenko, Ph.D.

AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

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Web: www.aier.org
Email: info@aier.org

Economic Bulletin
Vol. XLIX No. 2 February 2009
ISBN 978-091361065-7

Economic Bulletin (ISSN 0424–2769) (USPS 167–360) is published once a month at Great Barrington, Massachusetts, by American Institute for Economic Research, a scientific and educational organization with no stockholders, chartered under Chapter 180 of the General Laws of Massachusetts. Periodical postage paid at Great Barrington, Massachusetts. Printed in the United States of America. Subscription: $25 per year. POSTMASTER: Send address changes to ***Economic Bulletin***, American Institute for Economic Research, Great Barrington, Massachusetts 01230.

Preface

Where money and credit systems are unreliable or non-existent, saving is mainly hoarding. In many parts of the third world, for example, half-finished structures surrounded by stockpiles of building materials are a common sight. These represent savings of their owners, but it can take many years before such accumulations become useful. Borrowing for the construction of these buildings, a common practice in modern society, would dramatically speed up their completion.

Credit, in fact, is essential to the efficiency of a modern economy. In the United States, nearly all structures and most motor vehicles are paid for with borrowed money. Not all of these transactions are sound. Loans for the purpose of consumption or capital investment may be financed via inflating (creating money "out of thin air") rather than with genuine savings. And, as the mortgage meltdown of 2007-08 dramatically demonstrated, some borrowers simply cannot repay their debts.

From the consumer's point of view, there are three methods to finance current consumption: drawing upon past earnings that have been saved, spending current earnings, or borrowing against (pledging) future earnings. Each method has potential pitfalls. If savings are depleted by current spending, there will be nothing left for emergencies or for providing income for later years. If current earnings are spent imprudently—on luxuries instead of necessary food, clothing, or medical care—a family's well being could suffer. But by far the greatest consumption abuses have arisen from buying on credit.

For many, the drift deeper into debt occurs painlessly — and it is encouraged by both government policies and private lending practices. The result has been an alarming growth in consumer debt. The Federal Reserve reports that consumer debt in this country (excluding mortgages) totaled $2.59 trillion at the end of 2008. This is almost double the level of 10 years ago, and more than triple the level of 20 years ago. Bankruptcies reached an all-time high in 2005 of more than 1.7 million households.

The diversified consumer credit system often permits individuals to obtain a number of accounts with an aggregate limit that far exceeds a cardholder's ability to repay. This fundamental point seems lost on many credit users. Many people apparently regard the extension of credit as evidence that their incomes are adequate to pay back whatever debt they can run up on their various accounts. Worse, some consumers seem to regard credit as actual income rather than as a pledge against future income.

Either belief courts almost certain financial disaster. Unfortunately, many people realize this only when it is too late, as evidenced by a wave of foreclosures that followed the recent mortgage meltdown. Those who did not plan carefully when obtaining a mortgage found themselves in dire straits when housing prices fell. Learning where you stand with respect to income and credit and understanding the limits of reasonable consumption are basic first steps toward avoiding the abuse of consumer credit.

Beyond this, learning how to use credit to genuine advantage in today's complex marketplace can provide substantial benefits. Credit—particularly in the form of credit cards—can provide both convenience and safety at no cost to consumers. In some situations such as renting a car, it is a necessity. And when used properly, credit can actually *save* consumers money.

Although the ready availability of credit can be a great boon, it also presents costs and risks. These are the subject of this book. It describes how to establish and maintain a good credit rating, and also shows how to evaluate the costs involved and understand the consequences of becoming overextended. A newly expanded chapter on credit cards, complete with worksheets, is designed to help consumers successfully navigate through the often confusing waters of this common form of credit.

Dr. Rodolfo G. Ledesma prepared the original version of this book, published in 1989. Marla Brill revised the 2004 edition with assistance from the AIER editorial staff. Polina Vlasenko, an AIER research economist, updated this newest edition.

As part of the expanded treatment of credit cards, this new edition also includes information on new legal developments: the new rules for credit card practices that are scheduled to come into effect in 2010, and the bankruptcy law that came into effect in 2005.

American Institute for Economic Research
Great Barrington, Massachusetts
February, 2009

Contents

I.
Buy Now, Pay Later

Credit enables people to get the goods and services they want today in exchange for the promise to pay in the future. Such service is not free. The borrower's payment includes principal (the amount of credit granted), fees and service charges, and interest (or finance charge). Interest is the primary cost of credit, paid to the lender at some future date on the money loaned. Fees and service charges such as origination and processing costs are usually fixed supplemental costs. While they only indirectly raise the cost of credit, they still can amount to hundreds or even thousands of dollars, depending on the type of loan.

With home mortgages, the borrower's dollar payments including interest and other costs can total two or even three times the purchase price of the house because such loans call for repayment over decades rather than months or years. Yet most homes are purchased with mortgages.

This is because mortgages enable borrowers to have a home right away rather than after years of saving. Any such savings would have to be made after purchasing shelter, usually through rent. In addition, interest rates on primary home mortgages are generally the lowest available because the loans are secured by the property. And mortgage interest is deductible from taxable income for borrowers who itemize.

Other forms of credit may be considered as a convenience. A credit card purchase is a typical example of such a transaction.

Many vendors will accept a credit card where they would refuse a personal check from a customer who is not well-known to them. But, even when the balance due is paid within the account's billing cycle — so that no interest or finance charges are incurred — there are still costs associated with credit purchases.

Some credit cards charge an annual fee whether or not the consumer uses the card to make purchases or pays in full each month. In addition, the vendor usually pays a fee to the bank for processing a credit card transaction.

There can be a benefit to postponing payment through a credit purchase. This stems from the time value of money —or the income that money earns in an interest-earning account, such as a savings account, NOW account, or money market fund. As long as a consumer pays before a grace period ends and has been earning interest on the funds used for payment, credit purchases become more advantageous than cash transactions.

If the credit user's payment misses the grace period deadline, a credit purchase starts to be costly. If funds are in cash instead of in interest-bearing alternatives, there is nothing to offset the interest penalty that comes from paying after the grace period has expired. In general, as long as funds are kept in high interest-yielding accounts for a given credit period and full payment is made before the grace period expires, a credit purchase will be less costly than a cash transaction.

Credit disclosure laws require lenders to present interest rates and other borrower costs in a standardized format. Such disclosures enable prospective borrowers to comparison shop. On personal installment loans (whether or not they are secured by a motor vehicle or other personal property) the lender must disclose the annual percentage rate (APR), and the total of interest and other charges over the term of the loan, as well as the amount of the periodic (usually monthly) payment required. The somewhat more complex disclosures required for credit cards and similar accounts are discussed in Chapter III.

Credit's Hidden Impact

It is difficult to imagine situations in which it is not cheaper to pay cash. Someone who is very careful to make credit card payments when due (so that no finance charges are incurred), may be able to keep funds in interest-earning assets until the very last moment. However, even when this is done, the extra interest income earned must be larger than the credit card's annual fee to make the practice worthwhile.

Since vendors incur charges on credit card transactions, it sometimes is possible to obtain a discount for cash purchase, even when such discounts may technically be a violation of the vendor's agreement with the card issuer. This is more likely to happen when talking to the owner of a shop or business rather than to a low-level sales clerk.

The discount probably would not be more than 2 percent. But even 1 percent would be more than the same amount of money would earn in a few weeks in a savings account. In some cases, where a shopkeeper offers to let you take goods now and pay at the end of the month, for example, it is because the shopkeeper is anxious to make the sale. A more substantial discount might be forthcoming for immediate cash payment. Some lines of business, such as deep-discount mail order firms operating on razor-thin margins (these most commonly deal in specialty items such as personal computers and electronics, hobby supplies, or sports equipment, where the customer knows exactly what he wants at the best price), may not accept credit cards because of the vendor fee for processing the transaction.

In some cases the consumer might use a credit card to ensure the trustworthiness of the vendor, the very opposite of the usual situation of a vendor accepting a credit card rather than a personal check. This can apply to purchases such as tickets, where there is some doubt whether the goods or services will be used or delivered. It is often far easier to reverse a credit card transaction than a cash payment.

More generally, having credit available may mean that one can take advantage of exceptional opportunities. It may also mean that one need not tie up as much in accounts for emergency reserves.

The Risks of Using Credit

Once credit is obtained, a person's income, assets (perhaps also those of relatives), current standing with present creditors and the rest of the financial community, and future borrowing opportunities all are exposed to risk.

The ultimate risk is that the borrower will default on the commitment to repay the creditor. The credit contract usually involves an agreement, whether verbal or written, explicit or implicit, to pay the creditor at some future date. The ability to honor any credit obligation usually depends on the borrower's cash position at the payment due date. Many consumers gamble that this date will coincide with their ability to obtain cash, say, from employment. If these earnings do not materialize, the individual might have to draw down assets. Just having outstanding credit means exposing assets to the risk of loss.

If, at the due date, an individual is without cash or assets, the likelihood of default increases unless the credit terms can be restructured. Any financial restructuring (in bankruptcy or otherwise) with creditors can have an impact on a credit rating. Since this information is also passed along to other lending institutions, standing with them is also affected. This could mean reduced credit access, higher borrowing costs, or both.

Instead of a formal restructuring, the borrower may be able to find another willing lender who can assist in meeting current obligations. This option is especially common among heavy users of credit cards. Financially strapped consumers often obtain cash advances from one credit card just to make payments on other accounts.

This increasingly common situation often means that the borrower is devoting a significant portion of after-tax income to interest and other charges instead of for current consumption or savings. Ultimately, in exchange for what turns out to be a relatively brief acceleration of consumption, the debtor has a permanently lowered standard of living.

Perhaps the greatest risk of credit—and one that all too many credit card holders are willing to assume—is the mountain of debt that builds quickly with slow repayment. Making just the minimum payment each month puts a debtor on an endless and frustrating financial treadmill. The required minimum payment on a credit card account can be as low as 1 percent of the outstanding balance, which means that it will take many years to repay even a moderate balance. Credit card accounts are discussed in much more detail in Chapter II.

II.
What You Need to Know About Credit Cards

Even though credit card companies mail out billions of unsolicited credit offers annually, getting credit for the first time can be difficult and frustrating. Young people just starting out face the same problems as older people accustomed to paying cash who find they now need a credit card if they want to rent a car or reserve a hotel room.

College students with little income often have an easier time getting a credit card than many other individuals seeking credit for the first time. Card companies court students, regarding them as potential high-earning, long-term customers with good repayment records — especially since parents are likely to pay the initial bills if their children don't.

How to Establish Credit

Except for students, most people beginning their credit history seem to face an unwritten law: They must have credit to get credit. The information on a credit report has become all-important to lenders. Fortunately, there are ways to build a credit record even if a credit history has not been established.

Open a checking and savings account. Whenever you apply for credit, a lender will want to see that you have established these most basic bank accounts. In addition, the bank where you maintain your accounts will be more inclined to approve a personal loan or line of credit if you already are a customer.

Apply for a retail credit account. Trust builds on trust. Getting the first charge card usually poses the biggest hurdle. Once overcome, it is easier to convince other lenders of your creditworthiness. Local merchant accounts and oil company cards are easiest to obtain. However, they carry the least weight as credit references. Although more difficult to obtain, cards issued by national department store chains such as JCPenney and Sears are far more impressive retail credit references.

Before you apply for any retail credit, make sure the merchant will report your payment history to the three major credit bureaus: Experian, TransUnion, and Equifax. Creditors will generally turn to one of these bureaus to get a report of your credit history.

Once your credit is approved, build a good payment record with the retailer by purchasing items on credit and paying the bills promptly. Purchases need not be large or frequent, since your primary objective is simply to establish on a credit report that you pay your bills responsibly. Starting small with retailers is generally regarded as a useful step before applying for major credit cards such as VISA, MasterCard, American Express/Optima, or Discover.

Many retailers encourage customers to apply for their proprietary charge cards by offering discounts on purchases. Although such offers may seem tempting, be careful not to go overboard with retail store credit card accounts. Many of them have higher annual percentage rates than regular credit cards, so users could face sky-high interest charges if they don't pay off the balance each month.

Don't shop for several store cards at one time. Each time you apply for a card, the issuer will check your credit report and notice other inquiries. Having too many credit card inquiries raises a red flag and could lower your credit score because people who apply for credit often tend to have poor repayment records.

Find a co-signer. If your own credit history does not provide the prospective lender enough proof of your creditworthiness, a co-signer may improve your chances of getting credit. Co-signers accept the risk that you will make good on your promise to pay, since they are liable for your debt if you default on it. But co-signing is not for everyone. (The responsibilities of a co-signer are discussed at the end of this chapter.)

Often, children or spouses are added to credit card accounts as "authorized users." While this allows them to use a credit card, they generally are not contractually responsible for making payment, so this status is not considered a strong credit reference. A co-signer or joint applicant, however, shares responsibility for payment of the account and will get the full benefit of using the card as a credit reference. But if one co-signer is delinquent on payments, it negatively affects the credit reports of both parties. In addition, if one co-signer defaults, the creditor can look to the other co-signer for payment, no matter who benefited from the loan.

Apply for a secured credit card. To obtain a secured Visa or MasterCard, you deposit money in a savings account with the bank offering the card. Your deposit acts as security for your credit line. Credit lines are a percentage of the deposit, and usually range from 50 to 100 percent. Minimum deposits are usually in the range of $250-$500, although they can be as much as several thousand dollars. Usually, banks pay interest on deposits.

Secured cards generally charge an annual fee and a higher rate of interest than unsecured ones. After a period of one to two years, many secured cards convert to unsecured status. In any event, a good payment record will help on future credit applications. Make sure that the issuer of the secured card reports to the three major credit bureaus. If the issuer does not report, the card will not help build a credit history.

Secured cards are offered by many reputable banks. Unfortunately, deceptive ads and scams by unscrupulous credit repair companies seeking to take advantage of those who need to build or re-establish credit have proliferated in recent years. Some charge high application and processing fees (see Chapter IV). Others require applicants to call a 900 number, which can cost from $2 to $50 or more to use.

Check with your employer about getting a reference for a loan. In some instances, an employer might be a customer of a local bank and have an established reputation. If your company can vouch for you, that may help you get credit from the lending institution with which your company deals.

Check with your local credit union or other sources of affinity group credit. Some professional groups or associations have programs that help members secure credit. Some auto finance companies employ relatively lenient credit standards for young and promising college graduates who do not yet have a credit history.

If you are denied credit, find out why. The laws require creditors—when asked—to specify why an application for credit was denied. Individuals also have the right to obtain a copy of their credit reports free of charge within

60 days of being denied credit. Clarification or correction of the information provided to the lender may be what is needed to have an application approved. Details on the credit protection law and on how to proceed under these circumstances are discussed below.

How to Shop for Credit

Creditors extend secured and unsecured loans. A *secured* loan requires collateral backing before it is granted. The collateral is an asset — land, a home, a car — that can be sold to pay off a debt. With secured loans, the creditor can take possession of the pledged asset if the debtor defaults on the loan. Home-equity lines of credit and automobile loans are examples of secured loans.

An *unsecured* loan does not require collateral backing. Creditors view this as a more risky type of loan. It relies solely on the creditworthiness of the borrower and is not attached to any specific asset that can be seized and sold in case of default. Since unsecured loans are more risky, they carry higher rates of interest than do secured loans. Revolving credit (such as that provided by credit cards) and overdraft loans extended by banks to checking account customers are examples of unsecured loans.

Loan shopping is not unlike shopping for a house or apartment. It takes homework and, most likely, some legwork as well. After determining your needs, look at your alternatives. Begin with your current banker. For any given loan, you need to know the annual percentage rate, APR), the total fees and finance charges, the monthly payment and the total cost of the loan.

Credit Cards and Credit Card Rates

Comparison shopping for credit cards can save you money, since there are differences in annual fees, grace periods before interest accrues, and interest-rate charges — and even different methods for calculating finance charges. Some cards have no annual fees, but do not allow you a grace period before interest is charged. Others have high annual fees, but relatively low interest rates. Still others entice consumers with low teaser rates that jump to higher rates after the first six months. Adding to the mix, an increasing number of companies now sponsor "reward" cards that offer rebates on charges such as airline miles or a rebate that can be applied toward the purchase of a new car. What combination is best for you depends on how you plan to use your credit card.

There are three basic ways people tend to use credit cards: revolving a balance from month to month, having a card for convenience instead of extended credit, and combining a revolving balance with convenience usage.

The "revolver" generally pays only part of the outstanding balance each month, often just the minimum required payment. This minimum frequently is as low as 2 percent of the outstanding balance. For these credit users, the card's annual percentage rate (APR) is most important. Revolvers with high balances could benefit in the short term from a card with a temporarily low teaser APR — *if* they transfer a balance from a higher rate card and pay it off during the time the low rate is in effect.

Convenience users pay in full every billing cycle (usually a month) or before the grace period is up. For this type of user, the APR is not the most important attribute. Rather these consumers benefit most from cards with low or no annual fees and grace periods that allow at least 25 days before interest accrues on purchases. A convenience user who typically charges high balances might benefit from a reward card, if the value of the rebate is likely to outweigh any annual fee charged.

The combination user often pays the entire outstanding balance, but sometimes pays just part of it. All three card characteristics — the APR, annual fee, and grace period — are important. Combination users should look for the card with a low or no annual fee and a low APR. A long grace period is preferable for those times when the balance is paid in full. (In most instances, whenever any part of a balance carries over from month to month, the card company charges interest on new purchases immediately, eliminating the grace period.) Since rebate cards generally have high APRs, a combination user could find that the interest charges would be higher than the rebate offered.

How to Choose the Right Credit Card

Table 1 serves as a rough guide to choosing a credit card. Table 2 illustrates its use by showing a hypothetical sample of credit cards. You will have to go through the actual selection process to make the best use of this guide. When doing so, remember that applicants with a limited credit card history are less likely to qualify for the lower-rate cards.

When comparing annual percentage rates of different credit cards, find out

Table 1
Credit Card User Type and Card Attribute Guide

Type of Credit Card User	*Most Important Card Attribute(s) to Consider*	*Least Important Card Attribute(s) to Consider*
Revolver	APR	Annual Fee, Grace Period
Convenience User	Annual Fee, Grace Period	APR
Combination User	APR, Annual Fee, Grace Period	

whether the rates are fixed or variable. According to the Federal Reserve's 2008 *Survey of Credit Card Plans*, which covered 151 financial institutions, about 60 percent of credit cards have variable rates. A variable rate is usually tied to some market interest rate, called an index. The overwhelming majority of the credit cards use the prime rate as the index; this rate is regularly published in the *Wall Street Journal*. The APR on the credit card is determined by adding a margin or additional percentage points to the index rate, for example "prime rate plus 7.99%"; this APR changes when the prime rate changes.

When selecting a credit card among several with variable APRs, be aware of how the APRs are determined. Compare the margin that is added to the index, instead of simply looking at the current value of the APR. (But be sure to check whether the cards use the same index.)

For this example, let's assume that the prime rate is 6 percent.

If you are a revolver, pick Bank A's credit card. The interest rate is the most important factor for revolving credit. Bank A's APR is essentially the same as that of Banks C, D, and E, but Bank A's card is preferable because the APR is fixed. The variability of the interest rate on the other cards poses an additional risk if market rates increase. In addition, Bank A charges a lower annual fee than Bank D.

Credit card issuers can change their terms at any time, which means that Bank A's credit card may not remain the best choice forever. If Bank A decides to increase the APR on the card to, say, 14%, Bank B's card becomes more attractive. A credit card issuer is required to notify customers about changes in terms, which they usually do by including a note with the monthly statement. Always read the statements and accompanying correspondence carefully to determine which card is the best for you in the changing circumstances.

If you are a convenience user, choose Bank F's card because annual fees and grace periods are what matter most. Among the cards with no annual

Table 2
A Hypothetical Nationwide Sample of Credit Cards

Card Issuer	*APR*	*Annual Fee*	*Grace Period*
Bank A	12% fixed	$39	25 days
Bank B	13% fixed	none	none
Bank C	Prime rate + 5.99%	none	none
Bank D	Prime rate + 5.99%	$59	25 days
Bank E	Prime rate + 5.99%	none	21 days
Bank F	Prime rate + 6.99%	none	25 days
Bank G	Prime rate + 7.99%	none	25 days

fee, those offered by Bank F and Bank G both have 25-day grace periods, the longest on the list. Bank F also has the lower APR.

If you are a combination user, shopping for the best mix of a low APR and annual fee, and a long grace period, the cards issued by Bank E and Bank F offer fairly similar advantages. Cards from Banks A and D are out of the running because they charge annual fees. The cards from Bank B and Bank C have no grace periods. Of the remaining three contenders, Bank G charges the highest interest.

Choosing between Bank E and Bank F depends on individual circumstances. Bank E's card has the lower APR, but a shorter grace period. If you anticipate carrying the balance on the card fairly often, the lower APR provides more benefits.

Bank F's card has a slightly higher APR, but a longer grace period. If you anticipate carrying the balance on the card only very rarely, Bank F's card might work better.

These examples are rather simplified and do not take into account other factors that could affect an individual cardholder's cost when using a credit card. Among these other factors are fees for cash advances, late payments, and exceeding the credit limit.

The Federal Reserve's *Survey of Credit Card Plans* asked 151 institutions that issued credit cards in 2008 about the terms they offered. It found that:

- 114 credit cards have no annual fee. The others charge annual fees ranging from $12 to $95.
- Late fees per late payment range from $10 to as high as $39. Some credit cards have tiered late fees that increase with the size of the card balance.

- Over-the-limit fees range from $10 to $39 and very few cards (only 3 percent) charge no such fee.
- Almost all credit card plans have grace periods, ranging from 20 to 30 days. Only three cards have no grace period.
- 57 cards have fixed APRs, which range from 6.5% to 23.9%. 93 cards have variable APRs, which range from 6% to 24.5%. Among cards with variable rates, the margin ranges from 0.5% to 16.7%.

Most credit card companies charge cardholders a late fee if payments are not received by the due date. Many also may increase interest rates for cardholders who make just one or two late payments within a period of six months to one year. In addition, risk-based APRs that assign cardholders an interest rate based on their credit histories are becoming increasingly common.

Many of these costs and terms are tucked away in fine print. A credit card shopper should certainly read the credit contract agreement carefully before accepting its terms.

Recent news about credit card terms is not all bad. While high interest charges, annual fees, and late fees have certainly made using plastic more costly for many users, incentives such as rebates on purchases or frequent flyer miles have helped others save money. You can get a sampling of credit card incentives at websites such as CardWeb (www.cardweb.com) and Bank Rate Monitor (www.bankrate.com).

Words of Caution

Credit cards are a costly way of borrowing. Because they represent unsecured and, therefore, risky loans, interest rates are usually higher than on most other types of loans. It is not unusual for a credit card to have an APR as high as 19.99% or even 21.99%.

If you pay only the minimum payment every month, it will take years to repay even a moderate credit balance. In the process, you will pay very large amounts of interest. Usually, a minimum payment is 2 percent of the outstanding balance or $10, whichever is larger. Table 3 below shows how long it takes to repay a $1000 balance, by paying only this minimum very month.

These calculations are in many ways optimistic. The table assumes that the APR does not change during the time you are repaying the balance and that you make all payments on time so that you do not have to pay late fees or penalty

Table 3
How Long Does it Take to Repay a Credit Card Balance of $1,000?

If the APR on the credit card is:	10.99%	15.99%	19.99%	21.99%
The balance will be fully repaid in:	10.7 years	15 years	24.2 years	38.8 years
The total amount of interest paid is:	$570.33	$1,250.05	$2,756.70	$5,165.05

Note: This table assumes: 1. No new purchases are charged on the card. 2. Minimum payment is 2% of the balance or $10, whichever is larger. 3. The APR does not change during the time the balance is repaid. 4. All payments are made on time so that there are no late fees.

APR increases. If you are late with your payment, even only once, the higher penalty APR could run as high as 25 or even 30 percent. This will significantly affect the length of time it takes to repay your credit card balance.

Most credit cards have variable rates, so during the years it takes you to repay the balance, the APR is very likely to change.

The example in the table also assumes that you do not make any additional purchases with the credit card while you are repaying the balance. Making additional purchases will lengthen the repayment period. Making other transactions, such as cash advances, which almost always carry higher APRs than purchases, will increase the repayment time even further. Currently, most credit cards apply payments to the balance subject to the lowest APR first. For example, if you have a balance from purchases of $1000, which is subject to a 15.99% APR, and you take a cash advance of $100, which is subject to cash advance APR of 19.99%, the $100 of the cash advance will continue to accrue interest at the rate of 19.99% for years, until you repay all of the balance from purchases. Only then will your payment be applied to the cash advance amount.

Changes are Coming to Credit Card Practices

Because of extremely high APRs, many people find reducing their credit card debt difficult. And many do not realize just how expensive credit card borrowing can get until it is too late. To address these problems, the Federal Reserve Board, the Office of Thrift Supervision, and the National Credit Union Administration have adopted several new provisions regulating practices for consumer credit card accounts. These provisions will come into effect July 1, 2010.

The new rules require that credit card companies apply payments above the minimum to balances with the highest APR or pro-rata to all balances. Currently credit cards companies apply payments first to balances with the lowest APR. Once the new rules come into effect, the card companies will most likely apply payments pro-rata to all balances.

The new rules also will prohibit credit card issuers from increasing the APR during the first 12 months an account is open. There are three exceptions. Credit card companies can increase interest rates for accounts with variable APRs if the index interest rate to which the APR is tied (such as the prime rate) has increased. Introductory or teaser APRs can be increased if the date of the increase is disclosed at the time the account is opened. Credit card companies can also increase the APR if a payment was more than 30 days late.

In all cases when the APR goes up, even in the case of a penalty increase because of a late payment, the card issuer has to notify the customer at least 45 days in advance. In addition, the new APR will apply only to the transactions made *after* the rate change. Balances incurred before the rate increase will continue to accrue interest at the old APR. This represents a major change from the current practices, under which whenever the APR is increased, it applies to all balances outstanding on the account, new or old.

The new rules also require credit card issuers to send out billing statements at least 21 days before the due date to give customers sufficient time to submit the payment on time.

Many provisions in the new rules are aimed at increasing the information provided to consumers and making it easier for them to see the true costs incurred by borrowing with the credit card. For example, beginning July 1, 2010, when the new rules kick in, every billing statement must show the amount of interest incurred that month and separately list the amount of any fees (late fees, cash advance fees, and other). Each statement must also show separate year-to-date amounts for fees and interest. Monthly billing statements also must disclose the effect of making only the minimum payments on the time to repay balances.

Balance Transfers and Credit Protection

Credit card customers often receive special offers that can sound as confusing as they are enticing. It would be impossible to discuss in any detail the great multitude of these incentives, which range from rebate programs to membership in various organizations. Two types of special features are related to borrowing and credit: balance transfer offers and credit protection plans.

Balance Transfer Offers. In a balance transfer offer, a credit card issuer is essentially offering you use of the credit line of this card to repay other accounts, including other credit cards, loans, or unpaid bills (such as hospital bills). Some balance transfers can be directly deposited into your bank account, from which you can, presumably, pay your other creditors.

Balance transfer offers come in many forms – as a letter in the mail, as a note included with your monthly statement, or as a link included in your online statement (for those who signed up to see their credit card statements online).

Whether it is a good idea to take up these offers as means to repay other accounts depends on how the terms of the balance transfer compare to the terms of the other loans. To evaluate a balance transfer, three key pieces of information are required: the APR that is applied to the transferred balances, the length of time this APR remains in effect, and the transaction fee (also called "balance transfer fee") you will have to pay.

The first two pieces of information are usually easy to see in any balance transfer offer, but the transaction fee is often hidden in the fine print. In some cases, you even have to call the credit card company to find out the size of the applicable fee. It's critical that you do this. The APR information alone is not enough to evaluate the cost of the balance transfer—the transaction fee can significantly affect this cost and should be taken into account. On rare occasions, you might get a balance transfer offer for which the promotional APR lasts "until the balance is paid in full." In that case, the promotional APR is close to the true costs of borrowing, provided it takes several years to repay the balance.

Once you have the necessary information, use the worksheet on page 17 to calculate the effective interest rate that would apply to the transferred balances. Comparing this interest rate to the interest you are currently paying on your other accounts will help you decide whether transferring balances is worthwhile.

The example in the table calculates the real cost of a hypothetical transfer offer that reads: "Transfer balance today and receive 1.99% APR till January 1, 2010." Somewhere in the offer (quite possibly in fine print at bottom of some page) there is information about a transaction fee, which usually looks like this: "The transaction fee for this offer is 3% of each transfer, $10 min., $199 max." Transaction fees can vary dramatically: Some offers specifically say that there is no transaction fee; some offers do not have a maximum for the fee.

Read the balance transfer offer carefully and make a note of the following information on the top of the worksheet:

- The promotional APR that applies to the transferred balance. In our example, it is 1.99%.
- Promotional period – the number of months during which the promotional APR remains in effect. If today is April 2009, this number will be 8 in our example. (The balance transfer offer cannot be processed immediately, so the applicable months are approximately May through December of 2009.)
- Transaction fee information. In our example: 3% of the amount, minimum $10, maximum $199.

Keep in mind that the size of the transaction fee depends on the amount of the transfer. You will need to use the worksheet separately for each balance transfer you plan to do.

The first column presents a hypothetical case, where a balance transfer of $5,000 is contemplated under the conditions described above. The worksheet shows that, even though the offer advertises APR of 1.99%, once the fees are taken into account, the effective APR is significantly higher—6.49%. It would make sense to use this offer to repay another credit card that charges APR higher than 6.49%, *assuming* you plan to repay the balance in full during the eight-month promotional period. It would not make sense to use this balance transfer to repay the balance on your home equity line of credit that charges a lower APR, for example, 5.9%.

Once the promotional period for the balance transfer offer ends (on January 1, 2010, in our example), the APR on the remaining balance changes. Most often it reverts to the standard APR for purchases, which is always higher than the promotional interest rate for the transfer.

The worksheet allows you to calculate the effective APR on the transferred balances, *assuming that the balance is completely paid off during the promotional period*. If you are not able to repay the balance during the promotional period, the transferred balance becomes significantly more costly. As a practical matter, it is never a good idea to use a balance transfer to repay a long-term loan, such as a car loan. You car loan may have a higher interest rate, say 7.9%, than the effective APR of 6.49%, but the car loan has to be repaid over the next three

Worksheet: Effective APR on a Balance Transfer

Fill in these details from the balance transfer offer:	*Example*:			
Promotional APR	1.99%	%	%	%
Promotional period, in months	8			
Transaction fee, % of amount	3%	%	%	%
Minimum transaction fee	$10	$	$	$
Maximum transaction fee	$199	$	$	$

Computation:

1. The amount you plan to transfer	$5,000	$_____	$_____	$_____
2. Transaction fee (% of amount) if applicable; 0 if no fee	3%	_____%	_____%	_____%
3. Multiply line 1 by line 2	$150	$_____	$_____	$_____
4. Minimum transaction fee, if applicable; 0 if no fee	$10	$_____	$_____	$_____
5. Write the **larger** of the values in lines 3 and 4.	$150	$_____	$_____	$_____
6. Maximum transaction fee, if applicable; if no maximum, write the amount from line 1.	$199	$_____	$_____	$_____
7. Write the **smaller** of the values in lines 5 and 6.	$150	$_____	$_____	$_____
This is the balance transfer fee payable at the time of transfer				
8. Divide line 7 by line 1 (and multiply by 100 to get percentage)	3.00%	_____%	_____%	_____%
9. Promotional period, in months *	8	_______	_______	_______
10. Divide number 12 by the value in line 9 **	1.5	_______	_______	_______
11. Multiply line 8 by line 10 **	4.50%	_____%	_____%	_____%
12. Promotional APR for the balance transfer	1.99%	_____%	_____%	_____%
13. Add lines 11 and 12	6.49%	_____%	_____%	_____%

This is the effective interest rate that applies to the transferred balance

* For balance transfer offers with an APR that remains in effect "until the balance is paid off," the advertised APR is a good approximation to the true effective APR, provided it takes several years to repay the balance. ** Steps 10 and 11 translate the transaction fee into an annual interest rate.

years, while the transferred balance should be repaid over the much shorter promotional period. In rare cases, a balance transfer may offer an APR that lasts “until the balance is paid off.” If the APR in such an offer is noticeably lower than the interest rate on your other long-term loans, it may make sense to use the balance transfer to pay off the other loans.

The transaction fee applies every time you make a balance transfer. In our example, if you plan to use the balance transfer to pay a $300 medical bill, a $200 utility bill, and a $350 bill from a department store card, you will incur three transaction fees: $10 for the first transfer, $10 for the second one, and $10.50 for the third, for the total of $30.50. On the other hand, if you are able to use the balance transfer as a deposit into your bank account of $850, to pay all three bills, you would incur only one transaction fee in the amount of $25.50 (3% of the total amount of $850). Not all balance transfers allow you to have the money deposited directly into your bank account. But whenever this option is available, it is always the cheaper alternative--provided you have enough discipline to use the money to repay the creditors, instead of incurring more expenses.

When requesting a balance transfer, make sure you have enough credit available to accommodate the applicable transaction fee in order to stay within your credit limit (the worksheet shows the exact amount of the fee).

Be careful about using the credit card for purchases once you have used it for a balance transfer. Purchases usually carry a higher APR than the transferred balance under such special offers. And at least until July 2010, the credit card companies usually apply payments to lower APR balances first. This means that your payments will be applied to the transferred balance with low APR, while the balance from your purchases will continue to accrue interest at the higher APR. As a rule of thumb, the balance transfers are most advantageous when the balance is transferred onto a card that has a zero balance prior to the transfer, and the card is not used for any other transaction until the transferred balance is paid off.

Credit Protection Plans. In recent years, credit card companies began offering—sometimes very insistently—optional credit protection plans. These plans offer to make the minimum required payment on your credit card account when a qualifying event takes place. The qualifying events can include loss of a job, hospitalization, and even a long-distance move or a birth of a child. Some of these plans also offer to repay the full balance on your credit

Table 4
Comparative costs of credit protection plans

Fee (per $100 of balance):	89 cents	79 cents	69 cents
Effective interest cost:	10.68%	9.48%	8.28%

card in the event of your death, presumably so that your heirs do not need to worry about it.

The supposed advantage of such a plan is that it makes a minimum payment at those times when it may be difficult for you to do so, thus preventing you from incurring late fees and penalty APR increases – hence the name, *credit protection plan*, it "protects" you from ruining your credit history because of late payments.

However, these credit protection plans are not free. Their cost varies with the balance you have on your credit card and is usually expressed in the form of "89 cents per $100 of balance at the end of each statement period." Those who advertise these plans are quick to point out that if you have no balance on the credit card, this protection plan will cost you nothing. What they fail to mention is that if you have no balance on your credit card, you also have no need to make any payments on it and no need for the credit protection plan.

It is almost never a good idea to sign up for such credit protection plans. They are extremely expensive, and it is unlikely that their benefits outweigh the costs.

First of all, the plan charges a fee *even if you pay your balance in full every month*. The fee charged is usually quite high. If you have a $1,000 balance on the credit card, for which you pay only the minimum payment, and the fee for the credit protection plan is 89 cents per $100 of balance at the end of each month, you will pay a fee of approximately $8.90 every month, which is more than $100 a year. The plan's fee amounts to more than 10% of your balance, and this is *in addition* to the interest charges imposed by the credit card.

If you experience a qualifying event, the credit protection plan will make the minimum payments for you. The minimum payment is usually 2 percent of the outstanding balance, or $20 a month on the $1,000 balance. Under such a credit protection plan you pay $8.90 *every month* in exchange for the plan potentially paying at most $20 in *some months*. This is an extremely costly "protection." You can do better for yourself by putting $8.90 into a savings account each month and using this money to make payments on the credit card if you are hospitalized or lose a job.

III.
Borrowing Beyond Credit Cards

Credit cards are widespread, but they are not the only way of borrowing. Consumers often turn to other types of loans for high-ticket items such as cars or houses that they cannot afford to pay for with cash. Homeowners routinely borrow against the equity in their homes to finance various expenditures, ranging from home improvements to college tuition of their children.

Each type of loan has its own set of rules. Below are points to consider for some common types of borrowing.

Auto loans. Many people rely, for example, on dealer-arranged financing to pay for a car, and most dealerships have a finance and insurance department to arrange these loans. When you apply for a loan at a dealership, you are asked to complete a credit application. The dealer will then obtain a credit report that contains information about your payment records and current obligations.

Dealers typically sell your contract to an assignee, such as a finance company, and are often compensated for their services as a "go between" by rate markups. Your credit history, current finance rates, competition, market conditions, and special offers all influence the APR the dealer will quote to you. If the APR is part of a special offer, it may only be available to consumers with stellar credit, or be limited to certain makes and models of car. Unless the APR is part of a special financing offer, *it is subject to negotiation*.

The practices of dealership finance departments have come under scrutiny recently. According to a recent study by the Consumer Federation of America (CFA), car dealers routinely mark up auto loan rates as much as 3 percentage points over prevailing car-loan rates, regardless of the applicant's credit score. The study found that black and Hispanic buyers experience more frequent and higher rate hikes than whites. The CFA maintains that while dealers deserve to be compensated for arranging loans, that compensation should take the form of a fixed fee, rather than a rate hike. Given the mark-up dealers receive for arranging financing, it makes sense for consumers to investigate auto loan rates available from other lenders, such as banks or credit unions, before they set foot in a dealership.

Mortgages. The majority of people who buy houses do so with the help of a mortgage. A mortgage is a loan for which the house is pledged as the collateral. At one point, the world of mortgages was simple: A person could borrow up to 80 percent of the appraised value of the house. The majority of mortgages had a fixed interest rate and lasted for 15 or 30 years. Over the years, new types of mortgages appeared, with an especially large number of new and exotic types of mortgages appearing since the mid-1990s. Among these: adjustable-rate mortgages, interest-only mortgages, and negative-amortization mortgages. Following the financial turmoil of 2008, it is possible that some of these types of mortgages will disappear. Rather than attempting to provide an overview of the multitude of mortgages, we will concentrate on general advice.

Shop around before signing a mortgage. Do not rely solely on the real estate broker to find the mortgage for you. Terms and interest rates can vary considerably among different lenders, and since a mortgage is a large financial commitment, even small differences in interest rates can have a substantial effect. In today's world of fax, Internet, and phone connections, your local bank is not your only option for a mortgage lender.

Make sure you understand the terms of the mortgage contract before you sign it. Ask the lender to give you a copy of the contract several days before you need to sign it. Ask questions if anything is unclear. Consult a lawyer if necessary. The key features of a mortgage contract are the interest rate, the term of the mortgage, and various fees involved. It is crucial to know whether the interest rate on the mortgage is fixed or adjustable, and if it is adjustable—how often and how much it can change. You can ask the lender to compute what your monthly mortgage payment would be under various hypothetical changes in the interest rate.

There are various fees associated with the mortgage loan, such as application fee, loan origination fee, appraisal fee, and points. Make sure you know the fees applicable to your mortgage, because you will have to pay most up front, at the time when the mortgage is originated.

Federal Reserve provides consumer resources that help in understanding mortgages at http://www.federalreserve.gov/consumerinfo/mortgages.htm

In some cases, it may be more cost-effective to rent your residence rather than owning it. Notwithstanding what real estate agents would like you to believe, owning a home is not the best option for all people. AIER's book *Homeowner or Tenant? How to make a Wise Choice* describes the decision between owning and renting and provides an overview of various mortgage options.

Finally, it's important to remember that just because a bank is willing to approve a mortgage for you doesn't mean that you can afford to repay it. You know your income situation better than any bank ever will. The bank is protected against you defaulting on the mortgage by the collateral value of the house. If you are unable to pay your mortgage, the bank will foreclose on the house and recover at least some of the money it lent to you. But you will be left without a home. Plan carefully. Do not buy the largest house for which you can get a mortgage, but rather the house you can afford based on your income.

Borrowing against home equity. Another common form of debt uses the existing home equity as collateral. During the real estate boom that ended in 2006, as home values rose rapidly, consumers made ample use of the equity in their homes for purposes such as consolidating high-interest credit card debt, paying tuition bills, or making home improvements. Such an approach has advantages and disadvantages compared to credit cards or unsecured loans.

There are two chief advantages. The rates on these loans are often lower than most other forms of financing because they are secured by home equity. And the interest is usually tax-deductible.

The disadvantages come from the erosion of home equity the borrowing creates. Fluctuations in home values, and especially a sizeable decrease in the home price, may leave you "upside down" on your mortgage—owing more on your mortgage and home equity loan than the current market value of your house. Should your debt become unsustainable and you decide to file for bankruptcy, you will usually be able to get rid of credit card debt. But the debt from home equity loans will remain. (For more information about bankruptcy, see Chapter V.) Make the decision to borrow against home equity carefully. It is a good idea to leave a reasonable cushion of home equity untapped by any borrowing.

Borrowers can tap home equity in one of two ways. With a *home equity line of credit*, borrowers can write checks against the equity in their homes up to a pre-set limit. Depending on your creditworthiness and the amount of other outstanding debt, home equity lenders may let you borrow up to 85 percent of the appraised value of your home, minus the remaining balance on your first mortgage. Most home equity credit lines come with variable rates, which are usually pegged to the prime rate or other common benchmark. As with a credit card, there is no fixed period for paying off the loan, although minimum monthly payments are usually required. By contrast, you must pay a *home equity loan* (also known as a *second mortgage*) over a specific period. The loan comes with a fixed rate of interest and is for a fixed amount. While the fixed rate on a home equity loan may be slightly higher than the initial rate on a home equity line of credit, borrowers have the assurance that their payments will remain the same through the term of the loan.

When shopping for either a home equity line of credit or home equity loan, be sure to ask about extra costs such as application or loan processing fees, appraisal fees, or points. Anyone comparing the cost of a home equity line of credit to a home equity loan also should keep in mind that the annual percentage rate (APR) quoted by the lender for a line of credit is based on interest alone. In contrast, the APR for an equity loan includes other charges, such as points and closing costs. If you are considering a variable rate loan, be sure to check the periodic cap that limits interest rate changes.

If you are in a financially strapped situation (and are late on payments on credit cards, for example, because of a job loss), it will show up on your credit report. Banks will be unlikely to approve your application for a home equity loan or a line of credit. To have access to a home equity line of credit, establish it *before* you have a real need for it.

Borrowing against home equity can make sense for those who are able to spend within their means and borrow selectively. The major disadvantage is that borrowers who use their homes as collateral run the risk of foreclosure if they are late or have trouble making monthly payments. For that reason, consumers should not use home equity loans and home equity lines of credit to purchase discretionary luxury items.

Education loans. In an age where the cost of a college education runs well into six figures, borrowing to pay for college tuition is a necessity for many students and their parents. According to FinAid (www.finaid.org), a website about financial resources for college, two-thirds of four-year college students graduate with some debt, and the average student loan debt among graduating seniors is $19,237.

Education loans fall into three main categories. Federal student loans, also called Stafford and Perkins loans, do not require a credit check or collateral and have flexible repayment options. Federal parent loans for undergraduate students, or PLUS loans, are taken out by parents on behalf of dependents. Banks and other private lenders offer private loans, or alternative loans, to bridge the gap between the limited amounts available through the two federal loan programs and education costs.

Remember that education loans, just like any other loans, will have to be repaid from future income. Students assuming these loans should estimate future earnings realistically and plan carefully to make sure that the burden of the education loan is manageable. There is nothing magic about education—it doesn't warrant excessive borrowing. Many students tend to overestimate the income they are likely to get after graduation, which leads them to borrow larger amounts through student loans than they can comfortably afford. Conservative estimates of future earnings are always preferred to overly optimistic ones.

Federal education loan programs typically have lower interest rates and more flexible repayment options than do most consumer loans. You can also deduct up to $2,500 of the interest on these loans, regardless of whether or not you itemize on your tax return.

With college costs continuing to soar, financial aid counseling has become a growing business. Although some of these services are legitimate, many offer little beyond the information that is already available for free on the Internet, from school counselors, or from seminars at local schools and libraries.

Borrowing from a retirement account. It is possible to borrow money from an individual retirement account (IRA) or a retirement account offered by an employer (most often called a 401(k) plan). But borrowing from a retirement account is no small matter. The account is set up to accumulate assets for the time when you retire, and borrowing from it will reduce that amount. There also can be complicated tax implications. Contributions to retirement accounts are usually not subject to income taxes, but distributions are. In addition, the IRS changes applicable rules from time to time. So if you are contemplating borrowing from your retirement account, it pays to plan carefully and investigate current tax rules.

A loan from an employer's retirement plan is usually considered a taxable distribution. You will be expected to pay income tax on the amount borrowed, unless the loan meets certain criteria. Those include limitations on the amount of the loan and the time during which it is to be repaid.

It is possible to use an individual retirement account for short-term borrowing: You are allowed to take money from your IRA as long as you deposit it into another IRA, or the same IRA, within 60 days, without owing any income tax on the amount. Make sure that you redeposit the exact amount you have taken out and in the same form. (If you took cash from your account, depositing securities, even if of the exact same value, is not allowed). And remember that the 60-day rule is very strictly enforced by the IRS.

Credit Protection Laws

Creditors require credit applicants to submit a good deal of information about their creditworthiness. (How they use this information is the subject of the next chapter.) In the past, many applicants complained of being turned down or discriminated against on the basis of what they believed to be "noneconomic" considerations. In response, Congress passed the Equal Credit Opportunity Act (ECOA) in 1974.

The law does not guarantee that an applicant will get credit. But it does require a creditor to apply an impartial assessment of the borrower's creditworthiness and treat all applicants equally. It is illegal for the creditor to base a credit-granting decision on noneconomic factors such as age (provided the applicant can legally enter into a binding contract), sex, marital status, race, religion, or national origin. The law also makes it illegal for creditors to deny credit to people on public assistance such as Social Security or welfare. Such money counts as income.

Applicants 62 years of age or older must receive the same treatment as younger applicants (except minors) in terms of both creditworthiness and collateral requirements. The law also says that companies cannot refuse credit on the basis of marital status. Applicants do not have to use such designations as "Mr.," "Miss," "Ms.," or "Mrs." Creditors are required to count all income including that from part-time employment. However, child support and alimony payments need not be disclosed by the loan applicant. If the applicant chooses to include such income when applying, the law requires the creditor to count it as well. The same principle applies to annuities, pension payments, and other retirement benefits.

Disclosure laws, particularly the Truth in Lending Act and the Fair Credit and Charge Card Disclosure Act, are designed to help consumers make better-informed judgments as they shop for credit. Under the Truth in Lending Act, creditors must supply customers — in writing and before any contract is signed — with uniform information about the rates and terms of a loan. This enables loan applicants to evaluate terms offered by other sources. The annual percentage rate (APR) and the finance charge are the two basic information requirements. When credit is open-ended, as with retail credit accounts and credit cards, the lender is also required to disclose the method used in calculating the finance charge and the grace period. Advertising that misleads potential borrowers is prohibited under the provisions of this law.

The Fair Credit and Charge Card Disclosure Act further requires that credit card solicitations and loan applications divulge eight primary pieces of information. They are: the APR, annual fees, minimum finance charges, cash-advance fees, transaction charges, late or over-the-limit fees, grace period, and the method used in calculating the outstanding balance. This information must appear in a box format on most solicitations and applications (see Exhibit 1).

Another protection under the Fair Credit Reporting Act allows consumers to examine and correct mistakes on their credit records. And the Fair Credit Billing Act helps them address billing errors and thereby protect their credit record. (Specific provisions of these two laws are discussed in Chapter IV.)

Exhibit I: **Credit Card Agreement Disclosure Information**

Annual Percentage Rate for Purchases	15%
Annual Fees	None
Grace Period for Repayment of the Balance for Purchases	Not less than 25 days
Minimum Finance Charge	$.50 in any month that a finance charge is payable
Method of Computing the Balance for Purchases	Average Daily Balance (including new purchases)
Miscellaneous Fees	Cash Payment Fee: 2% of amount of the cash advance, or $10, whichever is greater Late Fee: $15 Overlimit Fee: $15

If a credit application is rejected, the federal regulations require that creditors must notify the applicant in writing within 30 days from the date of application that the application was denied. The creditors also must tell the individual if a credit reporting agency was a factor in the decision in refusing to grant the credit, and disclose which agency (name, address) provided the report. The notice must also provide specific reasons for the denial or inform the applicant of the right to request an explanation. If the lending institution used a "credit scoring" system to evaluate the applicant, the lender has to be prepared to provide the exact (but perhaps not as detailed as you would want) reasons for the low scoring categories that led to the negative decision. Lenders are not required to disclose your score.

Should You Co-Sign for Someone Else's Credit?

Co-signing for a loan is an enormous undertaking, which many people agree to without fully realizing the implications. The co-signer is *legally* bound to assume the debt if the borrower fails to make payment. This might be a responsibility you would be willing to take on for a child or parent. In general, though, the potential headaches outweigh any intrinsic rewards that might come from helping out a family member or friend. That said, here is what you should know before you decide to co-sign for any type of credit.

First, it is important to understand *why* lenders require someone else to co-sign for a borrower. Sometimes the borrower's own credentials do not meet the lender's criteria for granting the credit. In these instances, the loan (or credit card) is, in effect, being guaranteed by a co-signer who probably has a good credit history, a good earning capacity and liquidity position, a stable source of income, or other acceptable credit characteristics that the applicant may lack. Be aware that as a co-signer, you are being asked to take a risk that a creditor is unwilling to assume.

Make sure that you *can* afford to pay the debt in case you have to — which could involve the entire unpaid balance plus any late fees and collection costs. Most states allow creditors to collect from co-signers when the borrower misses a payment without first trying to collect from the primary borrower. Other collection methods, such as suits or garnishing of the co-signer's wages in order to collect, also are permitted in some states. A co-signer who defaulted on the inherited loan could be sued by the creditor. Any collection efforts are likely to appear on the co-signer's credit record, and remain there for seven years. And even though a debtor may be able to discharge repayment of a loan through bankruptcy, the co-signer can still be pursued by creditors for payment.

In addition, a co-signer assumes the risk to which the lender is similarly exposed — without the same monetary benefits the lender gains when a loan is repaid. Why? The lender's risk depends on whether the borrower can repay the loan and whether the amount repaid retains its purchasing power. This is the same risk the co-signer bears. However, when the loan is fully repaid, the lender gets back his money and interest (and purchasing power hopefully) while the co-signer gets nothing. A co-signer has done a friend or relative a favor, which may be an important intangible benefit. But the co-signer assumes an "imbalance" in the risk structure of the loan. When the borrower defaults, the co-signer assumes the debt obligation and may expose his/her wages and possessions to risk of loss to the creditor. In taking this chance, the co-signer receives no monetary benefits.

Take the example of an individual who co-signs a mortgage loan. The borrower maintains not only full ownership of the property but also derives benefits such as the tax-deductibility of interest payments or future borrowing opportunities (home equity lines of credit) that come with ownership in one's own name. The co-signer enjoys none of these benefits, but has to assume the burden of repayment in case of default. To share in the benefits of the loan, the individual may be better off as *co-applicant* or *co-borrower* rather than co-signer.

The co-signer should also consider the potential liability the debt will have when he or she applies for a loan. The lender might include the amount applicants co-signed for as part of total indebtedness or as a contingent liability of the co-signer. This additional debt may not be outstanding at the time the co-signer applies for a loan in his or her own right, but can become one if the borrower defaults. This is an additional risk that the lender has to consider in extending a loan to the co-signer.

The Federal Trade Commission's Credit Practices Rule requires creditors to supply *co-signers* (not co-applicants) a written notice that fully describes the extent of their liability. Be sure to obtain this before you co-sign. The repayment obligation of the co-signer usually includes the remaining principal and interest payments and a number of incidental costs, such as late fees. In some states it is possible for co-signers to protect themselves against late-payment fees, court costs, attorney's fees, and the like by limiting their repayment obligation to the principal amount. If the lender agrees to this provision, it must be stated clearly in the loan contract.

If you decide to co-sign, it may be wise to get a written agreement from the lender that you will be notified if the borrower fails to make a payment. Then, you can deal with the situation long before the loan goes into default. You should also get copies of all loan documents, including warranties, if you are co-signing for a purchase.

IV.
How Lenders Evaluate Your Credit Potential

Consumers often have no notion of how lenders view them. As a result, they may not understand the importance of the information they supply in credit applications, or how lenders use it. Knowing the factors that go into a credit evaluation offers some valuable clues about whether or not an application will be successful.

The Three "Cs" of Credit

When analyzing a credit application, a lender looks at the applicant's ability *and* willingness to repay. Increasingly, banks turn to scoring systems that help predict an applicant's creditworthiness. (In the case of credit card applications — where the creditor rarely meets the applicants — a computerized score usually determines the outcome.) Traditionally, creditors classify risks according to the three "Cs": character, capacity, and collateral.

Character refers to the applicant's willingness to repay the debt and to honor all obligations in the loan contract. Lenders routinely use information from a credit bureau report to see an applicant's payment history. They also look at factors such as job stability and home ownership.

Capacity refers to the applicant's ability to repay the debt, and has legal and economic aspects. If a loan has to be made to a minor, lenders usually require co-signatories such as parents or guardians. Credit analysts also look at a variety of other factors, among them: education, occupation or working skills, income, stability of employment, and age. They also look at obligations such as the amount of credit an applicant already has as well as the number of dependents.

Collateral is the portion of a borrower's assets that has been pledged to secure a loan. (If the borrower defaults, the lender can claim the collateral to satisfy the outstanding debt). Collateral can be a fixed asset financed by the loan such as a house or car, other assets, or a co-signer's personal guarantee. Collateral reduces the lender's risk, since a valuable asset can be taken if the loan goes into default. At the same time, it increases the borrower's incentive to make timely payments, since failure to do so could result in the loss of the collateralized property. Credit cards are generally unsecured loans, with no collateral backing up the debts. Consequently, lenders consider themselves to be assuming greater risk when granting credit cards, and usually charge a higher interest rate than on a secured loan. Most banks also want to see previous successful credit card experience when evaluating a credit card application, to indicate a good record in handling unsecured debt.

How Lenders Score Credit

Lenders rely heavily on computerized credit scoring systems, which analyze a number of factors that are considered predictors of how an applicant would repay the debt. Points are assigned to each of these factors — more points to favorable ones and fewer to less desirable ones.

Most lenders use a system that is based on either a credit bureau model or an application or customized model. The credit bureau model calculates a score only from information on a credit report. The application or customized model derives a score from a combination of information from an application and a credit bureau. Either type of score falls into a numerical range, indicating the risk level of a loan. The higher the score, the lower the risk.

The credit industry stresses that scoring systems do not determine the ultimate outcome of a loan application — lenders do. And the importance of a credit score in the decision-making process varies from lender to lender. Some large lenders have automated the evaluation process to a degree that subjective judgment no longer plays a significant role on many loans, especially when a high score indicates a low-risk loan. (These lenders argue that a well-refined scoring process results in faster, more accurate, unbiased decisions on low-risk applications. This allows loan officers to spend more time evaluating less clear-cut credit risks.)

Smaller lenders may be more likely to rely on both a credit score and a loan officer's judgment. With credit card applications, lenders tend to make a decision exclusively on the results of a computerized credit score. A loan officer may not personally review the application unless the score is on the borderline between acceptance and rejection.

Credit scoring allows lenders to quantify credit risks consistently. A particular lender decides the level of risk it will undertake on a loan. The applicant's credit score is compared with a threshold number generally used as the cut-off for decisions. A total higher than the cut-off indicates that the applicant meets the statistical requirements for approval. A total below the cut-off indicates that the candidate does not fall within generally accepted statistical risk limits, but does not necessarily imply outright rejection. In close cases, creditors often view the formal credit score by itself as indeterminate or inconclusive—and in these instances, the loan officer relies on personal judgment that, presumably, is based on past experience. One thing to remember: creditors make it part of the credit analysis process to verify the information an applicant supplies in the application form.

Credit scoring systems may include dozens of factors. There is no single universal way of computing a credit score. Different banks and companies can use their proprietary methods of computing the score, but these methods do not vary dramatically. A similar set of factors affect the credit score, no matter the method used to compute it.

According to Fair Isaac and Company, which develops the most commonly used models (models that produce the so-called FICO score), five factors carry the most weight in scoring:

Credit payment history. This record is probably the single most important measure of a borrower's character. Since the borrower's character is the hardest category to quantify, creditors rely heavily on a person's history of debt repayment as a measure of creditworthiness. Credit bureau reports contain information on delinquent payments on credit cards and loans. They also keep track of excellent bill-paying habits over the previous seven years.

Creditors look at how serious, how recent, and how frequent late payments have been within the seven-year reporting period. For example, a 30-day late payment would not be as troubling as a 90-day delinquency. However, if a credit report shows that several 30-day late payments in recent months, an applicant would probably be viewed as a greater risk than someone with a 90-day delinquency several years ago. Finally, if a pattern of late payments (even minor ones) is spread across a credit history, a lender would be concerned about the applicant's ability to repay the loan.

Level of debt utilization. Applicants who are at or close to their credit limits will generally lose points in a credit scoring system. Statistically, borrowers who have maxed-out on their credit lines pose more of a risk to lenders.

Length of credit history. The more years of credit experience an applicant has, the better the score.

Number of new credit applications. Each application for credit generally gets posted to a credit report as an inquiry. Too many inquiries (usually four or more in a six-month period) cause an applicant to lose points on a credit score. People who apply for credit often tend to have poor repayment records. In the past, consumers who have shopped around for a car or home loan would get multiple inquiries listed on their credit reports, even though they were, in effect, seeking only one loan. Credit scoring systems now try to correct this misinterpretation by treating all applications for a car or home loan made within a seven-day period as a single inquiry.

A good mix of credit experience. Having several major credit cards, as well as installment credit such as a car or student loan, improves a credit score. (On the other hand, a finance company loan may count against an applicant, since such lenders tend to work with riskier clients.) Creditors are more favorably inclined toward borrowers who have already passed tests for creditworthiness — but only if the record of credit usage indicates reliability. Because of the wave of personal bankruptcy filings and loan defaults in recent years, many creditors actually may give fewer points for possession of five or more credit cards.

A number of other factors may also play an important part in credit scoring, depending on the type of scoring model.

Annual gross income. Generally, the higher the applicant's income, the more points are awarded in a credit scoring system. It's beneficial for a credit applicant to reveal all sources of income, including interest income, child support, alimony, and others such as veterans' benefits and Social Security. (You are not required to list alimony, child support, or separate maintenance income.) In a scoring model that relies on information exclusively from a credit bureau, neither income nor debt-to-income ratio (detailed below) would be factors — though lenders would certainly view each as a primary indication of repayment ability.

Debt-to-income ratio. Debt-to-income ratio is obtained by dividing the monthly debt payments — which include payments on credit cards, personal loans, school and car loans, but exclude payments on first mortgages, home-equity loans, and rent—by the applicant's income. This measure provides lenders with some approximation of a borrower's debt-servicing capacity — that is, the ability to handle the additional debt (and hopefully any financial reverses that may occur after taking on the additional debt).

Lenders vary as to whether they use gross income or net income in the ratio. They vary, as well, in what they consider to be a favorable debt-to-income ratio. For some, a ratio of 20% would cause concern. Others easily approve a borrower with a 28% ratio. In any event, the higher the debt-to-income ratio, the greater the debt burden. Too large a debt load can stand in the way of credit approval.

Measures designed to quantify the existing credit experience. These measures can include the average length of time the applicant had revolving credit accounts (such as credit cards). The length of time is averaged over all revolving accounts. The longer the average time, the higher the score because being able to maintain accounts for a long time is a sign of responsibility.

Another measure is the average credit line per revolving credit account. The higher value shows that other lenders considered the applicant a good enough credit risk to extend a large credit line and that the applicant was responsible enough to be able to handle such credit lines. A high average credit line tends to improve the credit score.

Occupation. This category tries to measure the value and stability of different occupations. Managers and professionals are usually the highest point-getters under this category. Their jobs are usually more difficult to replace than those of unskilled workers. Sales occupations that depend entirely on commissions may receive lower points because of the relative unpredictability of that source of income. The same is often true for self-employed individuals.

Applicant's age. Older people usually get more points than younger ones. (If you are 62 or older, you must be given at least as many points for age as any person under 62.) However, applicants in their 20s may score higher than people in their 30s and 40s, who may have reached their peak earning years and who tend to already have major financial commitments to car, school, mortgage, and insurance payments.

Homeowner or renter. Substantial equity in a home indicates a favorable net worth position and, as such, a good credit risk. In a credit crunch, a homeowner can get home equity lines of credit to meet payment obligations. Homeowners rate better than renters under this category, provided that homeowners have substantial equity in their home. It is possible, through an unwise home-buying decision and mortgage choice, for a homeowner to end up with negative equity in their home (a case when mortgage amount exceeds the resale value of the house). Such "homeownership" will adversely affect a credit score. But because mortgages are collateralized debt, they have little weight as a credit reference for unsecured debt such as credit cards.

Length of stay at current residence. Individuals who are constantly changing their places of residence are likely to receive fewer points than those who tend to stay longer in one place. An applicant who has lived at the same place for more than four years receives the maximum allowable points for this category in some scoring systems. Stable residence patterns closely correlate with payment stability.

Job stability. As with a long period at one residence, job stability is another strong predictor of repayment ability. Consumers who have been at their current jobs for a number of years receive more points than those with less than a year of service.

Checking/savings account. Lenders look most favorably on loan applicants who have both checking and savings accounts. Those who successfully maintain such accounts demonstrate financial responsibility by maintaining proper records to ensure that there are sufficient funds in the account to cover checks written and by accumulating funds in anticipation of large payments. Needless to say, it would reflect most unfavorably on the applicant if the bank's records showed many checks returned for insufficient funds.

Tips for Improving Your Credit Score

The best way to get a high credit score is to use credit responsibly, have a good mix of credit, pay bills on time, and to have a stable and high-paying job. These are things we all strive for, but they can be achieved only by consistent behavior over long period of time. However, certain steps that do not require applying for new credit or finding a new job can improve a credit score.

Merge several credit cards of the same issuer into one card. Most credit card issuers offer a variety of credit cards. It is not unusual for a person to end up with two or even three credit cards issued by the same major bank, which were obtained at different times. The credit cards usually differ in their terms (one may be MasterCard, the other Visa; they may have different interest rates; one may offer rebates, the other airline miles, etc.). However, it is always possible to call the bank that issued the cards and ask them to merge these cards into one, which will have the larger combined credit line. This will increase the average credit line per revolving account, and will thus improve your credit score.

Be sure, however, to think carefully about the terms on the accounts you are merging. Decide terms of which account you like best (be that the lower interest rate or bonus airlines miles) and tell the card issuer that that is the account you want to keep. The bank will almost always comply with your request, which means they will cancel the other card and add its credit line to the card you indicted as preferable.

Cancel credit cards with low credit limits. If you have credit cards with very low credit lines, such as $500 or $1,000, consider cancelling them. This is unlikely to cut too much into your ability to borrow, but will increase the average size of the revolving accounts you have and improve your credit score. Quite often low credit limit cards are issued by retail stores. Most people use these cards rarely, which is an additional reason to cancel them.

Avoid applying for new credit cards. A new credit card reduces the average length of time all revolving accounts have been open. If the new card has a lower credit line than the old cards, it can reduce the average credit line. You should avoid applying for new cards if there is no real need for additional credit.

People who have credit cards receive offers to apply for new cards quite often. Sometimes these offers even come from the bank whose credit card a person has already. Filling out one of the credit card offers may not be the best way to increase available credit. Instead, call the issuers of existing credit cards and ask for a credit line increase. Often the increase can be granted on the spot—the credit card company has not granted it to you simply because you have not asked for it yet.

The credit line increases might be even easier from a bank whose credit card you already carry that has offered you another card. Tell the bank you would prefer the credit line increase on your existing card instead. A credit line increase is beneficial to your credit score (it increases the average credit limit per revolving account), while obtaining a new card might hurt your credit score.

Reduce the outstanding balances. The outstanding balance on credit cards represents the level of debt utilization and affects a credit score. The level of debt utilization is often classified in categories, such as "the balance is below 50% of the credit line" or "the balance is over 90% of the credit line," and these categories are applied separately to each credit account you have.

It is preferable to keep the outstanding balances below 50% of the credit line on *each* credit card. It is better to have $2,400 balance on each of two credit cards with $5,000 credit limit apiece than to have a $4,800 balance on one card and zero balance on the other. Having one credit card close to its credit limit lowers the credit score, even if other cards have zero balances.

Limitations of Credit Scoring Systems

In their current form, the statistical credit scoring methods have many critics. One limitation is that they tend to focus on abstract reports and statistical data to the exclusion of personal contact with the borrower.

A Congressional committee once asked the great banker J.P. Morgan to state the most important consideration in making a loan. Without a moment's hesitation, Morgan replied, "Character." In the days when credit checks were largely a matter of personal recommendation among loan officers, the highest credit rating was "any amount." This did not necessarily or even usually mean that the applicant was possessed of a vast fortune, but rather that, in the opinion of the person providing the reference, *the applicant was not a person who would borrow more than he or she could repay*.

Credit scoring systems bring far more information and rigor to the process of determining who will repay a loan, but the hoped for result of the process is the same — finding people who will not borrow more than they can repay. Credit card issuers usually increase credit card limits for customers with good payment records. People with well-established credit with several major credit cards will eventually find that the sum of their available credit limits is far more than they would feel comfortable in borrowing. Not maxing out their accounts and defaulting was the behavior that Morgan summed up as character.

Credit scoring approaches this question in a statistical and probabilistic manner. But this can mean that the most prudent and financially responsible applicant can have a hard time obtaining credit simply because he or she has never borrowed money before. In addition, the rigid categorization of behavior implicit in credit scoring provides little room for discretion or consideration of unusual circumstances. For example, an applicant may lose points for having multiple credit inquiries within a six-month time.

Although scoring models now treat numerous car or home loan credit inquiries made in a seven-day period as a single inquiry, a consumer with an otherwise sterling credit record who happens to apply for several forms of credit over a longer period could be turned down. An oft-cited example is Lawrence B. Lindsey, a Federal Reserve Board member who was denied a credit card because of multiple inquiries. It turns out that Governor Lindsey had eight inquiries over a six-month time — largely because he was refinancing his mortgage and moving his home equity line to another bank. In addition, he happened to apply for another credit card, as well as overdraft checking. The bank that rejected his application also admitted that Governor Lindsey lost points because he did not have a savings account.

Another concern is that applicants don't routinely learn their credit scores. The credit industry argues that it would be expensive to provide and explain scores to applicants, and individuals might be more likely to be confused than enlightened by the information. They further contend that consumers have legal access to credit bureau reports, from which much of the scoring data is compiled. Unsuccessful credit applicants must be told the reason(s) they were turned down. Since credit card companies do not disclose scores, unsuccessful credit applicants would be well-advised to explore the reasons with a lender, so that the decision could be re-evaluated.

The credit may be easily forthcoming if it turns out that there are errors in the credit bureau report — or even in the data entry of the credit application. But if the applicant's history still does not fit the mold imposed by the scoring system, and the applicant is less eminent than Governor Lindsey, the answer still could be no. This is why it is important to understand what lenders are looking for.

V.
Maintaining a Good Credit Rating

For years, banks, finance companies, savings and loans, credit unions and retailers have relied on consumer credit information supplied by either local or national credit bureaus. Credit bureaus assemble and disseminate millions of consumer credit reports annually. Most of them store and distribute credit reports through one of three national systems: Experian, TransUnion, and Equifax.

Creditors regularly report how customers use and pay their accounts. In turn, lenders have ready access to the current credit history of most loan applicants. What many people do not realize is that they have access to the same information.

Credit Reports

Ask your bank for the name of the credit reporting bureau (or bureaus) it uses. You can then order a copy of your report from the credit bureau, for a nominal fee or for free.

You can get a report free of charge if you request it within 60 days of having been denied credit, employment, or insurance as a result of your credit record. In addition, a recent amendment to the federal Fair Credit Reporting Act requires each of the nationwide credit reporting bureaus – Experian, TransUnion, and Equifax – to provide you with a free copy of your credit report, at your request, once every 12 months. The Federal Trade Commission provides information on how to obtain the free credit report (see http://www.ftc.gov/freereports), and warns against various companies and websites that, under the guise of providing a free credit report, try to collect personal and financial information about you.

Checking your credit report periodically is a good idea for all consumers.

It is especially important to do so several months before applying for a major loan, if possible. You then have enough time to correct any errors before they affect a creditor's decision. (It can take up to 30 days for a credit bureau to investigate information you dispute.) For details on obtaining your credit report from the three major bureaus, contact:

Experian, www.experian.com; P.O. Box 2002, Allen, TX, 75013, (888) 397-3742
Equifax, www.equifax.com; P.O. Box 740241, Atlanta, GA, 30374, (800) 685-1111.
TransUnion, www.transunion.com; 2 Baldwin Place, P.O. Box 2000, Chester, PA, 19022, (800) 888-4213.

Your credit record essentially is a snapshot of your credit accounts and how you handle them. Each credit bureau has a different reporting format, sometimes including a set of codes that may be difficult to decipher. To help you understand the contents, a credit report is generally accompanied by an explanation of how to interpret the information.

All credit reports include your name, address, Social Security number, and date or year of birth. You may also see your spouse's name, your former addresses, and information about your employment.

The credit bureaus regularly update your credit report to include your current payment history and level of debt. The report will also include a detailed record of late payments. Public record information such as tax liens, judgments, and bankruptcies appear as well. The credit bureau also keeps a list of queries about your credit record received by the bureau in the past two years. Unfavorable information about your payment habits and matters such as court judgments and tax liens remain on your record for as long as seven years. Personal bankruptcies can be kept on a credit report for up to 10 years.

Certain information may not appear. Student loans, even those in good standing, may be unreported. If lenders do not report the mortgage payment transactions of homeowners to credit agencies, then those payment histories will not appear.

The Fair Credit Reporting Act

The Fair Credit Reporting Act (FCRA) provides borrowers some protection against erroneous and outdated credit information that could jeopardize privacy and future borrowing opportunities. Under this legislation, the consumer has the right to contest the items in a report that are inaccurate or outdated. Credit bureaus must investigate disputed items within 30 days. If the organization that reported the information cannot verify it, the item must be deleted from your report. If a creditor verifies incorrect information, you are able to sue for damages.

When incorrect data are found and changes are made, the individual can have the credit reporting agency notify lenders who received the inaccurate report in the last six months. In addition, corrections to credit bureau reports must be communicated to other credit reporting agencies. (In the past, consumers had the burden of correcting the same error with each and every credit bureau.) A credit bureau will also have to provide the consumer with a free copy of a credit report that has been revised after investigation of an error.

If a disputed item is verified by a creditor, you have the right to add a statement to your credit file explaining your side of the dispute. This information must be included in future credit reports. The law also limits release of your credit report to people and organizations with a legitimate business need for the information. This includes credit grantors, landlords, insurance companies, and current and prospective employers.

Credit Complaints

Credit card accounts in particular are subject to a variety of billing errors that can be costly. These include:

- Charges for merchandise you did not buy, or a service you did not receive.
- Unauthorized credit card purchases charged to your account.
- An item is listed with the wrong amount or date of purchase;
- The credit card company fails to credit your account for a payment or the amount of a returned item.
- Mathematical errors in the entries.

You should read each monthly statement carefully to catch any such errors promptly. You also should keep all the receipts for items you charge, so you can check that they appear correctly in your bill. A general rule is: *when there are entries that you find unclear, ask*.

The intent of the Fair Credit Billing Act (FCBA) is to help consumers quickly correct billing errors that, if neglected, could harm their credit record. This legislation was passed in response to complaints by credit card users who thought they were wrongly billed and could not get the problems rectified by the merchants involved. Credit card issuers continued to charge interest even when such disputes remained unsettled, and the failure to make payments in such instances sometimes resulted in a blemished credit record.

Under the provisions of the Fair Credit Billing Act, the consumer has 60 days from the date the bill was mailed to notify the creditor *in writing* about any errors. While not required by the law, it is wise to send all such letters by certified mail, return receipt requested. Make sure your letter is sent to the address specified for billing inquiries; your complaint is likely to be lost if it is included with your monthly payment.

The creditor has 30 days to respond but no more than 90 days to resolve the disagreement. In the meantime, the borrower can withhold interest and minimum payments on items in question but should continue payments on undisputed amounts. The creditor cannot declare the borrower delinquent on bills that are the subject of controversy, nor try to collect such bills. Creditors cannot report the nonpayment to credit bureaus while the dispute is being resolved. A list of specific steps you can take in handling billing problems is shown in Exhibit 2 on pages 46-47, which is a typical notice supplied to cardholders by credit card issuers.

This law effectively makes credit cards preferable to cash in at least one respect. If you pay cash for an item and it is never delivered, it may be very difficult and time consuming either to get it or to get your money back. If you use a credit card to order the item, you can refuse to pay the credit bill if the item is not delivered. Travelers have confronted just this situation on a number of occasions when an airline or tour packager suddenly ceased operations. Those who charged the tickets to a credit card account could dispute the charge and withhold payment. Those who paid cash had no such option.

The law also provides that in the case of lost or stolen cards, the cardholder need not pay for any unauthorized charges *after* notifying the card issuer. A cardholder's liability for unauthorized charges is limited to $50 per card. In other words, as long as the loss of a card is reported immediately upon discovery, the customer's liability is limited to $50 even if hundreds of dollars of unauthorized purchases are made.

In recent years, many credit cards started offering zero liability on unauthorized transactions. In some cases, the zero liability applies only to online transactions. Read your credit card agreement carefully for any requirements that go with the zero liability provision (such as, when and how you have to report the unauthorized use).

Avoiding Credit Card Fraud

Losing a credit card or having one stolen can be vexing. Falling victim to increasingly sophisticated Internet predators and other scammers can damage your credit history because the cardholder may not learn of the fraud until weeks after it occurs. A few simple steps can help consumers avoid becoming victims of credit card fraud and identity theft.

Watch for suspicious e-mails. In "phishing," one of the latest and most widespread e-mail fraud schemes, scammers send out messages that appear to be from legitimate companies. The messages say the supposed company is working to enhance security and prevent fraud, or to update your account information. To help, they ask that you re-confirm your identity by entering personal information such as your Social Security number, credit card number, or login and password for the online access to your account.

Legitimate credit companies will never ask you to re-confirm your account information for any reason. You can safely assume that any e-mail that requires you to provide your account information is a scam. To be absolutely sure, you can always call the company (using the phone number provided on your credit card or on your statement, NOT in the e-mail in question) before you respond to any such request. Check for misspellings, grammatical errors, or obvious factual errors. Legitimate companies usually employ copywriters and proofreaders. Scammers don't.

Practice financially safe online behavior. Most banks and credit card companies allow customers to sign up for online access to their accounts. This is a valuable tool because it allows you to monitor your transactions and available balances, verify whether payments have been received, and make payments online. Monitoring accounts online regularly will alert you to any suspicious transactions a lot sooner than periodic printed statements, enabling you to resolve the problem sooner and more easily. However, online access to financial information also opens up possibilities for fraud and identity theft.

To make sure that online access is a benefit and not a curse, follow safe

Exhibit 2: **In Case of Errors or Inquiries About Your Bill**

The Federal Truth in Lending Act requires prompt correction of billing mistakes.

1. If you want to preserve your rights under the Act, here's what to do if you think your bill is wrong or if you need more information about an item on your bill:

  a. Do not write on the bill. On a separate sheet of paper write (you may telephone your inquiry but **DOING SO WILL NOT PRESERVE YOUR RIGHTS UNDER THIS LAW**) the following:

    i. Your name and account number.

    ii. A description of the error and an explanation (to the extent you can explain) why you believe it is an error.

    If you only need more information, explain the item you are not sure about and, if you wish, ask for evidence of the charge such as a copy of the charge slip. Do not send in your copy of a sales slip or other document unless you have a duplicate copy for your records.

    iii. The dollar amount of the suspected error.

    iv. Any other information (such as your address) which you think will help the creditor to identify you or the reason for your complaint or inquiry.

  b. Send your billing error notice to the address on your bill which is listed after the words: "Send Inquiries To:."

  Mail it as soon as you can, but in any case, early enough to reach the creditor within 60 days after the bill was mailed to you.

2. The creditor must acknowledge all letters pointing out possible errors within 30 days of receipt, unless the creditor is able to correct your bill during that 30 days. Within 90 days after receiving your letter, the creditor must either correct the error or explain why the creditor believes the bill was correct. Once the creditor has explained the bill, the creditor has no further obligation to you even though you still believe that there is an error, except as provided in paragraph 5 below.

3. After the creditor has been notified, neither the creditor nor an attorney nor a collection agency may send you collection letters or take other collection action with respect to the amount in dispute; but periodic statements may be sent to you, and the disputed amount can be applied against your credit limit. You cannot be threatened with damage to your credit rating or sued for the amount in question, nor can the disputed amount be reported to a credit bureau or to other creditors as delinquent until the creditor has answered your inquiry. **HOWEVER, YOU REMAIN OBLIGATED TO PAY THE PARTS OF YOUR BILL NOT IN DISPUTE.**

4. If it is determined that the creditor has made a mistake on your bill, you will not have to pay any finance charges on any disputed amount. If it turns out that the creditor has not made an error, you may have to pay finance charges on the amount in dispute, and you will have to make up any missed minimum or required payments on the disputed amount. Unless you have agreed that your bill was correct, the creditor must send you a written notification of what you owe; and if it is determined that the creditor did make a mistake in billing the disputed amount, you must be given the time to pay which you normally are given to pay undisputed amounts before any more finance charges or late payment charges on the disputed amount can be charged to you.

5. If the creditor's explanation does not satisfy you and you notify the creditor **In Writing** within **10** days after you receive his explanation that you still refuse to pay the disputed amount, the creditor may report you to credit bureaus and other creditors and may pursue regular collection procedures. But the creditor must also report that you think you do not owe the money, and the creditor must let you know to whom such reports were made. Once the matter has been settled between you and the creditor, the creditor must notify those to whom the creditor reported you as delinquent of the subsequent resolution.

6. If the creditor does not follow these rules, the creditor is not allowed to collect the first $50 of the disputed amount and finance charges, even if the bill turns out to be correct.

7. If you have a problem with the quality of property or services purchased with a credit card, you may have the right not to pay the remaining amount due on them, if you first try in good faith to correct the problem with the merchant. There are two limitations on this right:

   a. You must have bought them in your home state or if not within your home state within 100 miles of your current mailing address; and

   b. The purchase price must have been more than $50.

   However, these limitations do not apply if the merchant is owned or operated by the creditor, or if the creditor mailed you the advertisement for the property or services.

practices for online behavior.

Think carefully when creating a user name and password for any online account. Never use a complete word that can be found in a dictionary as your password. Professional scammers use software that tries *every* dictionary word as the password, so no matter how exotic or complicated the word you have chosen, they will find it. Many companies that offer online access create requirements for passwords that make them more secure, such as requiring that the password be at least a certain length and contain both letters and numbers.

It goes without saying that you should *never* share your password with other people. Changing your password periodically, for example, every six months, is also recommended.

Create different passwords for different accounts. It may be convenient to have the same password for all your online accounts, but it is also dangerous. If someone somehow finds out the password to one of your accounts, all your other accounts will become vulnerable.

Never click on any links in an e-mail that seems to have come from your bank or a credit card company, even if the e-mail looks legitimate. Many banks and credit card companies have a messaging center online where they duplicate any messages they have e-mailed to you. So go directly to the web page of the bank, log in as you normally do, and look for the same message on the official website.

You should not click on a link provided in an e-mail even if the link seems to be from your bank (such as http://www.ABCbank.com) – text in the e-mail can be made to look legitimate even if the link does not connect to the website of the bank listed. Even if, after clicking on the link, the website layout looks familiar or even identical to the website of your bank, do not assume it is safe. Fake websites can be made to look like the real thing. Here are a few steps you can take to recognize a fake website:

Check to see if the website you are logging into is secure. The login page of a legitimate website is always secure. This means that the web address begins with https://. Note the letter “s” at the end of “https.” Addresses for websites that are not secure start with http://. However, fake websites can also be secure. So, if a website is secure, it does not necessarily mean that it is safe.

When you first establish the online account access to your bank or credit card account, which should always be done from your home computer, check the option for the site to “remember your user name” (many websites offer this option). This means that when you access this website in the future, it will automatically display your user name in the appropriate field. Only the real website will be able to do it. Fake websites do not know your user name and therefore will not be able to display it. This will be a telltale sign of a fake website phishing for your financial information. Do not, however, have the site remember your password.

Make sure to have good anti-virus software that is updated regularly on your home computer. Many computer viruses are designed to collect sensitive information from your computer. Never access sensitive financial websites from an unfamiliar computer, such as public computers in airports, hotels, or cyber-cafes—often some of the information you view or enter can be later retrieved from the computer you used, so you can never be sure who will see your information after you are done using the computer.

Never give out credit card information over the phone unless you have initiated the contact. To be sure you are dealing with a legitimate source, call the company's customer service number or check its website for any scam alerts. If you do not wish to be solicited by telephone, contact the National Do Not Call Registry at 1(888) 382-1222 or https://www.donotcall.gov/

Only give credit card information to sites with a secure server. Secure servers encrypt information as it is being transmitted so that outside interceptors cannot read it. A site with a secure server will have an address that starts with https://. A site that is not secure will show an address starting with http://.

Check your credit history once a year. Many people do not find out about identity theft until they are denied loans because of actions taken by identity thieves. Checking your credit history periodically can help avoid prolonged misuse of your personal information. Currently, consumers can check their credit report for free once a year.

Pay attention to billing cycles and check your account statements. A missing credit card bill could mean an identity thief has taken over your account and changed the billing address to throw you off.

Tear up pre-screened credit card offers so no one else can fill them out in your name. Better yet, call 1-888-5-OPTOUT (1-888-567-8688) or visit www.optoutprescreen.com, a number and website maintained by the three credit bureaus for consumers who do not wish to receive such offers.

If you become a victim of identity theft, call the toll-free fraud alert number of any one of the three major credit bureaus to place a fraud alert on your credit report:

Equifax:	(888) 766-0008
Experian:	(888) 397-3742
TransUnion:	(800) 680-7289

This can help prevent an identity thief from opening additional accounts in your name. After one bureau confirms a fraud alert, it will automatically notify the other two.

How to Rebuild Your Credit History

Having an application denied by one creditor does not mean you cannot qualify for credit elsewhere. At the very least, you should use a credit denial as an opportunity to examine your credit report. If you have been turned down for credit, you can receive a free copy of your credit report within 60 days of your denial. The lender should furnish you the name and address of the credit bureau. Write, go online, or call them to request a copy of your report. (The credit bureau will want to see a copy of your letter of denial when you write for a report.) Examine the content of your credit report, paying special attention to the items responsible for your denial.

If the report contains negative but accurate information, then you need to begin rebuilding your credit history. Start by identifying the unfavorable item(s) in your record. If, for example, you are currently behind in your installment payments because of a temporary difficulty, offer to pay your creditors any charges due so you can clear the account. Make sure that credit bureaus revise your records to reflect that your payments are up-to-date on the account.

A financial restructuring may be required if the delinquency problem is more serious. In this case, you need to negotiate new terms and repayment schedules with your creditor(s). Lenders may be willing to restructure the term of the loan for a longer period. In the end, you will have paid more in interest, but you will also have lower and therefore more manageable monthly payments. Some lenders may offer you a debt consolidation loan, so you are making a single payment each month. View this solution with caution, especially when the debt consolidation comes in the form of a home equity loan. If you fall behind on payments, you risk losing your home to foreclosure. Unless excessive spending is truly under control, a debt consolidation loan simply plugs a hole in a dam that is bound to burst.

If you are seriously delinquent on an account, you may begin hearing from an outside collection agency. When this happens, consumers have certain protections under the Fair Debt Collection Practices Act. Debt collectors are not permitted to harass you, make false statements, or use unfair practices when trying to collect a debt.

(For a detailed review of the specific provisions of the act, readers are referred to the booklet *Fair Debt Collection*, available from the Federal Trade Commission, www.ftc.gov/bcp/, (877) 382-4357.)

Many people who are having trouble dealing with creditors — or who just want to prevent credit problems from escalating into more serious situations — find it helpful to deal with Consumer Credit Counseling Service (CCCS), a nonprofit network of over 1,300 offices. Their counselors can help you prepare a budget and work closely with your creditors on a debt restructuring plan that satisfies both parties. Contact the National Foundation for Consumer Credit (www.nfcc.org; (800) 388-CCCS) for information on the nearest office in your area. Many of the CCCS agencies have free counseling programs, while others charge either a monthly fee or an up-front fee or both.

However, credit counseling services, including those in the CCCS network, are *not* your advocates. The majority of their financing comes from the credit industry. Critics claim that some credit counseling services are little more than dressed-up collection agencies. Their first priority is to get you to repay your debts, which may or may not be the best option for you. Whether it makes sense to work with a counselor to set up a debt management plan depends partly on the terms of the plan. A badly structured repayment plan could actually make your situation worse.

The quality of credit counseling services varies widely. To increase your chances of dealing with a reputable agency, you should deal only with a nonprofit counselor. You should also ask about fees and find out how long it will take you to repay your debt and how much interest you will pay. Check with the Better Business Bureau to see if any complaints have been filed about the counseling agency, and find out about refund policies in the event you are not satisfied with their services. Finally, after embarking on a repayment plan, you should monitor the statements you receive from your creditors to make sure that your debts are being repaid as scheduled.

Credit Repair Companies

Be very wary of advertisements by so-called credit clinics or credit repair companies that promise a quick fix to your debt problems. These outfits are usually out for a quick buck and a quick get-away. Their exorbitant fees (ranging from hundreds to thousands of dollars) and dubious guarantees easily distinguish them from legitimate, nonprofit credit counseling services.

The scams perpetuated by most credit repair clinics rely on the provision of the Fair Credit Reporting Act that allows consumers to dispute items on their records. Because the law requires the credit bureau to revalidate a disputed item within 30 days of a verification request or else delete it, these fly-by-night services expect to overwhelm the particular credit bureau with so many verification requests that it misses the deadline and is forced to drop some items. But these tactics do not work for long.

Unfavorable but accurate information is not erased so easily. Credit bureaus are permitted to refuse to reinvestigate requests that appear frivolous. Some items may be dropped from the individual's record as the credit bureau misses the deadline. But, if they are subsequently verified as correct, they can appear in the next update.

Another scheme used by credit repair firms is a promise to create a new identity for individuals with a poor credit history. This involves applying for an Employer Identification Number, and using it in place of your Social Security number when applying for credit. The federal government considers this an illegal practice.

Credit clinics may also guarantee to obtain a new credit card for a not-so-modest fee of a few hundred dollars. This gimmick is often a secured credit card. For example, a credit clinic may arrange for an individual to open a savings account of $1,000 and obtain from the bank a credit card with a limit of somewhat less than the deposit. The bank may charge the individual its own application fee for issuing the card. As detailed in Chapter II, most people can get a secured credit card without the services of a credit repair clinic — at far more favorable terms.

Another credit repair scam involves so-called nonprofit credit counseling or debt negotiation organizations that promote themselves as an alternative to bankruptcy. Some of these organizations claim they can negotiate with creditors to lower credit card bills anywhere from 10 percent to 50 percent. Individuals using such services send payments to the debt negotiation company, which is then supposed to forward the money to creditors. There is no guarantee that the credit card company will accept partial payment of a debt. Late fees and interest charges could accrue on unpaid balances, exacerbating an already precarious debt situation.

In October 2003, the Internal Revenue Service, the Federal Trade Commission, and state regulators issued an alert to consumers about these firms, which use their tax-exempt status to add legitimacy to their claims. They also use their nonprofit label to circumvent state and federal consumer protection laws, since statutes regulating credit counseling agencies often do not apply to charitable organizations under IRS rules. The regulators warned consumers to beware of high up-front enrollment fees or required “voluntary contributions” or “donations” that, along with high monthly service charges, add to debt and lengthen the time it takes to pay off bills. The Federal Trade Commission provides tips on identifying credit repair scams and allows consumers to file a complaint on its website at www.ftc.gov/bcp/.

Individuals who seek the services of these firms have some protection. It is illegal for credit repair organizations to advise consumers to alter their identity or make misleading or untrue statements to creditors or credit reporting agencies. A credit repair firm must give customers a contract (that can be cancelled within three business days) explaining the services it will perform and the cost of these services. Most importantly, a credit repair company cannot collect its fee until the services outlined in the contract have been performed.

Even with these protections available, consumers would be well-advised to think carefully about working with these firms. Checking any such company’s reputation with the local Better Business Bureau and consumer protection agency would be a wise precaution.

Despite the shady reputation of the credit repair industry, some legitimate organizations have helped pull thousands of consumers out of debt. But working with even the most reputable credit counselor can blemish your credit report, since lenders view such activity as indication that you are a bad credit risk. Before you resort to a credit repair clinic, try to get your debt under control yourself. Many lenders and card issuers have departments that deal specifically with borrowers undergoing financial hardship. They may be willing to make special arrangements that will allow you to pay off your debt without damaging your credit rating.

VI.
The Consequences of Unwise Credit Use

Financial flexibility is the major advantage of the readily available credit that comes with a good credit rating. The ability to draw on lines of credit allows borrowers to take advantage of exceptional opportunities that may arise or to meet unforeseen expenses with little difficulty. Being able to pay for something on credit can be convenient and may allow negotiations for a better price. But these advantages involve a paradox: Credit may be most useful when it is not used.

After a person becomes indebted, payments of interest and principal begin to erode financial flexibility. Home mortgages and even car loans are seldom problematical, as long as the property that secures the loans is commensurate with income. Home mortgage obligations, however, can become problematic, especially if the value of the property securing them decreases significantly, as was the case during the mortgage crisis of 2007-08.

If a mortgage is obtained under overly optimistic expectations about future appreciation of the property and without careful planning for meeting future (possibly higher) payments, the home mortgage debt may lead to major financial difficulties. Problems most often arise when items of daily consumption have been purchased with unsecured credit, so that payments for past consumption curtail the ability to pay for today's needs (See the box on the next page).

In some instances, a sudden change in circumstances creates a problem. Loans that appeared insignificant can become burdensome in the event of the unemployment, disability, or death of a breadwinner. A divorce, acrimonious or not, can drastically alter financial circumstances. Large medical expenses, or an adverse court judgment not covered by insurance, can suddenly increase debt. Secured loans are seldom the main problem. A debtor can sell the house, the boat or the car to pay off the lender. But unsecured debts, which must be repaid out of income, can become unmanageable.

Between 1980 and 2007, Americans collectively increased their total household debt much faster than their disposable incomes (see chart on page 57)—in large part because of the ease of obtaining mortgages, home equity loans, credit cards, installment loans, and cash loans from a variety of sources. The housing and credit crisis of 2007-08 led to the reduction in mortgage debt, but the consumer debt has not fallen.

For many, the drift into deeper debt occurs painlessly. A diversified consumer credit system often permits individuals to obtain a number of credit accounts with a total credit line that far exceeds their ability to repay. This fundamental point seems lost on many credit users. Many people seem to regard the extension of credit as *prima facie* evidence that their incomes are adequate to pay back whatever debt they can run up on their various accounts. Some people learn otherwise only when bankruptcy is imminent.

Budgeting—keeping track of income and expenses—can help people avoid

Signs That You Are Overextended

Credit problems do not descend on people overnight. If you are relying heavily on debt, some readily apparent signs can indicate that you may be heading for trouble.

- The amount of minimum monthly payments on all credit accounts, excluding rent, mortgage, and utilities, exceeds 20 percent of your net monthly income. Or if you include mortgage payments, the amount exceeds 50 percent.
- You find yourself juggling payments among creditors. The most immediate due date determines which of your creditors gets paid next. You consistently pay only the minimum required every billing period to keep yourself afloat.
- You have exhausted sources of credit that are immediately and easily available and must rely more frequently on the overdraft credit line on your checking account.
- You are denied new credit. In this case, creditors already think you are a high risk. Even if you have not defaulted on a loan, creditors judge that your liquidity or net worth position is precarious.
- You are drawing more and more on your pool of financial assets, savings, or other investments that have been set aside for future use.

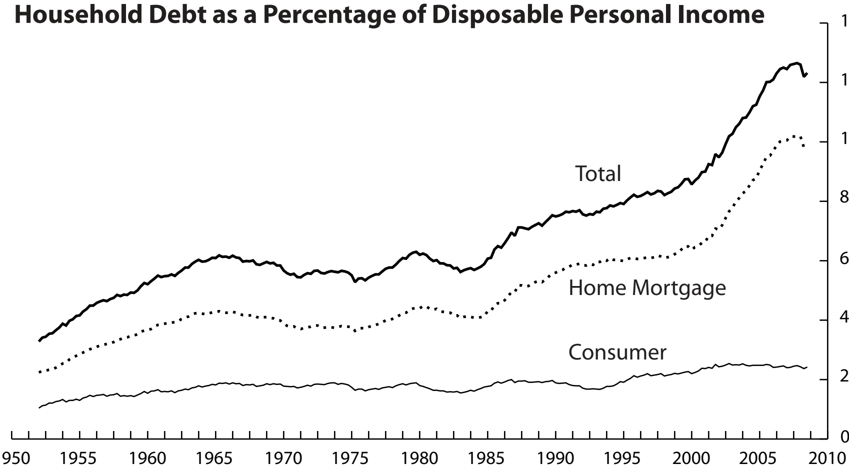
financial disaster. By itself, learning where you stand will not provide the discipline to stay within your means. However, it is a basic step in avoiding the abuse of credit that led to economic ruin for so many families. A sensible budgeting process provides many benefits. It coordinates short-term and long-term spending needs and preferences. It helps budgeters spend their money on what they determine are their most urgent wants. And it acts as a standard against which performance can be measured.

Failure to repay borrowed money was once regarded as a form of theft. Insolvent debtors were sent to debtors' prison. The *threat* of incarceration may have intensified the efforts of debtors and their families to make payment, but imprisonment did not serve to make debtors productive or enable them to return funds to creditors.

Insolvent debtors are no longer viewed as criminals unless they obtained loans by fraudulent means and/or with no intention of repaying them. No one is forced to extend credit and, when a loan goes bad, the lender may be responsible to some extent. Lenders need to review the circumstances of prospective borrowers, but even where such investigations are thorough and accurate, circumstances can change in ways that cannot always be foreseen.

Debts may be restructured by negotiation, or under the supervision of a court in a bankruptcy proceeding. Bankruptcy proceedings are designed to enable all creditors to receive equitable treatment, while enabling the debtor to restructure or discharge debts and have a "fresh start." Since the Constitution was first ratified by the states, bankruptcy has been handled in federal court.

Household Debt as a Percentage of Disposable Personal Income



The Framers viewed this as a means of ensuring a national economy. Credit can flow freely within the United States because borrowers cannot hide behind the individual state laws.

Voluntary bankruptcies, including Chapter 11 proceedings (used mainly by business), Chapter 12 (designed for farmers), and Chapter 13 (used mainly by individuals) allow the debtors to retain control of assets, while they renegotiate debt payments. Voluntary bankruptcy proceedings call for the debtor and the creditors to negotiate a plan for repayment, which can involve a reduction in the amounts due, postponement of payments, changes in the rate of interest, or all three in combination. Once a plan has been approved by the court, the debtor "comes out of bankruptcy" with restructured debts.

In Chapter 7 proceedings, an officer of the court takes control of a debtor's assets and distributes them to creditors. Individuals are allowed to keep certain assets. These traditionally included equity in a home, a car, clothing, tools of a trade and retirement accounts. The amount a bankrupt debtor can keep has increased over the years, especially since the 1978 revision of the federal statutes, which took effect in 1980. Where state laws differ from federal statutes, the debtor can elect for the more generous set of rules.

Soaring Bankruptcies Lead to Revision of the Law

The number of bankruptcy filings quadrupled from 1980 to 2005. They peaked in the fiscal year that ended September 30, 2005, with 1,748,421 bankruptcies, the highest for any year on record. This represented a 10.4 percent increase from the year before and more than a doubling over the preceding decade.

The dramatic increase in bankruptcy filings was one of the main reasons for the most recent revisions to the bankruptcy law. The Bankruptcy Abuse Prevention and Consumer Protection Act (Bankruptcy Act of 2005), came into effect in October 2005. The law makes it considerably more difficult for consumers to file for Chapter 7 bankruptcy (straight liquidation) and instead directs them to Chapter 13 (reorganization of debt). As a result, the number of personal bankruptcy cases, especially the number of Chapter 7 cases, fell considerably in 2006 and 2007. The total number of personal bankruptcies filed during the fiscal year ending September 30, 2007, was only 775,344—down nearly a million from the 2005 levels. At the same time, personal bankruptcies filed under Chapter 13 increased from about 25 percent of all bankruptcies in

2005 to about 40 percent in 2007. Bankruptcy filings were on the rise again in 2008, however, they are far below the peak reached in 2005.

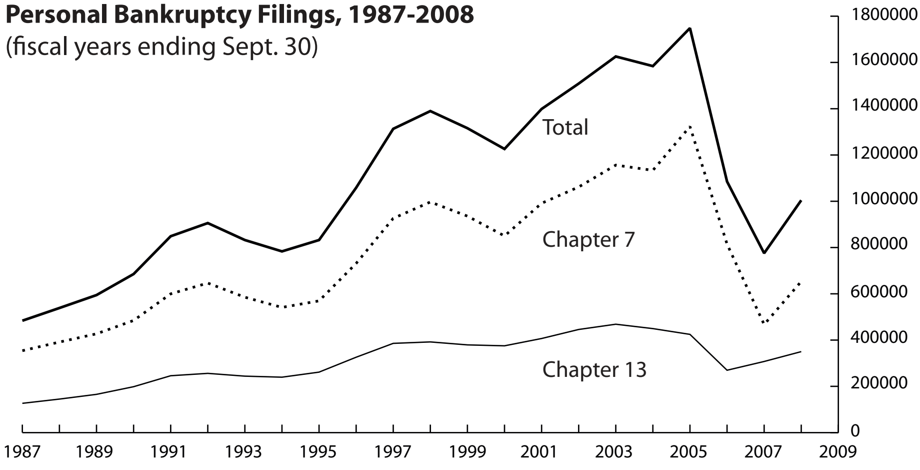
Chapter 7 proceedings still account for most personal bankruptcies. In almost all Chapter 7 cases, most debtors do not have assets that can be distributed to creditors. Most of the assets distributed in the remaining Chapter 7 cases appear to be assets of bankrupt businesses.

An increasing proportion of personal bankruptcies involve overextended consumers who have run up substantial balances on multiple credit card accounts and are tired of juggling balances and paying significant portions of their disposable incomes in interest. In a 2007 survey of individuals receiving credit counseling services, the nonprofit Institute for Financial Literacy found five chief reasons for financial distress. These were: overextended on credit, unexpected expenses, reduction in income, job loss, and illness/injury. Many of the 36,907 respondents ultimately filed for bankruptcy, and on average, each listed three causes for their problems. In other words, the financial distress often was a result of a combination of bad planning and adverse circumstances. Those who are overextended on credit, for example, usually are the least able to deal with a job loss or serious illness.

Alternatives to Bankruptcy

Bankruptcy should be considered only as a last resort. There are direct costs of filing for bankruptcy and a filing may remain on a credit record for as long as 10 years. Once used, debtors cannot file for bankruptcy for another

Personal Bankruptcy Filings, 1987-2008
(fiscal years ending Sept. 30)



eight years. And although it is often possible to obtain credit after a bankruptcy, it is usually expensive and limited.

Begin taking steps to avoid declaring bankruptcy at the first inkling of trouble, especially when the difficulties are related to a sudden change in circumstances. It's important to scale back on consumption and to inform creditors of the situation. Creditors do not like to be surprised. Falling behind on payments without notifying the lender is probably the worst course a troubled debtor can take, since it usually hastens legal action on the part of the lender. It is vastly preferable to communicate, making partial payments of monies owed if possible, than to simply stop making payments and say nothing.

Borrowers who have simply defaulted may find it difficult to keep creditors from exercising creditor remedies such as wage garnishment, wage assignment, repossession, and deficiency judgment. These legal actions, actual or threatened, are what usually precipitate a bankruptcy filing.

Having wages garnisheed by a creditor is not a casual matter. It is disruptive, and, depending on state law, it could threaten a borrower's very survival if the garnishment leaves an individual without enough money to meet even basic living expenses. Repossession of a car could leave a debtor without the transportation needed to stay employed or conduct business. This, in turn, could bring more legal actions by other creditors. Or, if a deficiency judgment precedes the repossession, the borrower's credit record could reflect that and severely restrict future borrowing.

Troubled borrowers are advised to resist the advice of lawyers who may want their business in a bankruptcy proceeding or of friends, relatives, and acquaintances who urge that bankruptcy is the "smart way out" of a financial jam. With the wider availability of credit counseling services from Consumer Credit Counseling Service, most financially distressed debtors can receive reliable information about alternatives to bankruptcy at little or no cost. Even if such services do not guarantee protection from legal actions, there is a good chance that creditors will participate in a CCCS-arranged repayment plan. A well-designed plan by a reputable credit counseling agency can help rebuild credit and avoid bankruptcy.

Deciding on Bankruptcy

Under the Bankruptcy Act of 2005, not all debtors can freely choose which type of bankruptcy to file — Chapter 7 or Chapter 13.

Chapter 7 is *straight* bankruptcy, and is referred to simply as "bankruptcy" in the following discussion. Under Chapter 7, many (but perhaps not all) of a bankrupt's debts will be forgiven. Most of the bankrupt's assets will be sold to pay creditors. Secured creditors have first claim to the proceeds while unsecured lenders divide whatever remains. A bankruptcy filing is reflected in the debtor's credit record and remains there as long as 10 years.

Chapter 13, sometimes called a *wage-earner plan*, is intended for persons with steady incomes who can repay debts but need court protection from creditor harassment. The borrower is permitted to keep all assets during a period during which they make a sustained effort to repay most, if not all, outstanding obligations. The repayment plan can run for three or five years. Since it involves a rehabilitation or reorganization of the consumer's indebtedness, Chapter 13 is not technically regarded as a bankruptcy.

The Bankruptcy Act of 2005 introduced a number of changes that make filing for Chapter 7 bankruptcy more difficult. A means test, which involves comparison of monthly income to expenses and debt repayment obligations, determines whether the debtor is able to repay at least a portion of the debts under a Chapter 13 repayment plan. If monthly income is deemed to be sufficient for repayment, the debtor cannot file for Chapter 7. Creditors can challenge the debtor's eligibility for Chapter 7 and petition to have the case dismissed or converted to Chapter 13.

The new rules also require more accountability on the part of a debtor's attorney. By signing a bankruptcy petition, an attorney certifies that he or she has performed an investigation into the debtor's circumstances and determined that Chapter 7 filing is warranted. If it turns out that the debtor fails the means test and the bankruptcy case is dismissed or converted to Chapter 13, the attorney may be liable for court costs and fees. In practice, this means that attorneys should be less willing to file Chapter 7 petitions and prefer Chapter 13 cases.

In addition, all debtors are required to have undergone credit counseling within the six months preceding their bankruptcy filing. The law also expands the list of nondischargeable debts and extends from six to eight years the time before a debtor can file for bankruptcy again.

Overall, changes in the law make it considerably more difficult to discharge debts under Chapter 7. Many debtors who would have previously opted for a Chapter 7 filing now have to file for a Chapter 13 restructuring plan, which can last up to five years.

As in most decision-making situations, the most useful way to proceed is to compare bankruptcy with all available alternatives. This requires determining eligibility for Chapter 7 in the first place and then comparing bankruptcy to other options. This may not be easy if a creditor has already obtained a court order to garnish wages and a decision must be made immediately.

Moreover, determining the market value of assets that might be sold to satisfy debt obligations can be time consuming. Projecting future income, expenses, debt obligations, and asset acquisitions (under each alternative and under bankruptcy) to determine a reasonable after-bankruptcy budget is next to impossible.

Although it's hard to clearly assess the situation, there are several considerations that ought to be taken into account before a decision to file bankruptcy is made. Of primary importance is the matter of which debts are *dischargeable* and *nondischargeable* under bankruptcy. A *dischargeable* debt is one that a bankrupt is no longer legally bound to pay after a bankruptcy filing. Credit card debts, medical bills, utility bills, and unpaid rent fall into this category. Most unsecured debt is dischargeable.

Nondischargeable debt remains even after a bankruptcy filing. Traffic tickets, alimony and child support, income taxes (with some exemptions), and student loans, both government and private, are examples of this type of debt. Some secured debts, such as mortgages, are also nondischargeable. If a large proportion of debt is nondischargeable, then bankruptcy would provide relatively little relief.

It also is important to determine what personal belongings are *exempt* and *nonexempt* under bankruptcy. Bankrupts are permitted to retain possession of a property that is on the exempt list of the state or federal government. Statutes hold that the bankrupt individual should be able to keep some basic items needed to make a "fresh start." But creditors (or, more precisely, the bankruptcy trustee) can take nonexempt property as part of the bankruptcy proceedings and liquidate it to pay off debts.

The classification of a bankrupt's property depends on the election of either a state or federal exemption, but not both or a mix of both. State and federal exemption schedules differ significantly, and which may be most advantageous depends on individual circumstances.

Distressed borrowers who think that a bankruptcy filing may be the best (or only) way out of financial trouble are well-advised to consult an experienced bankruptcy attorney who can thoroughly explain both the advantages and disadvantages of the process. The American Board of Certification (877-365-

2221; www.abcworld.org) can provide referrals to attorneys who have satisfied the Board's standards for education and experience in handling bankruptcy cases.

Further Reading

Books

Detweiler, Gerri, *The Ultimate Credit Handbook: How To Cut Your Debt and Have a Lifetime of Great Credit,* (The Penguin Group, 3rd edition, 2003). A comprehensive guide to establishing, building, and improving credit. Chapters on choosing credit cards, dealing with credit bureaus, and reducing debt are especially helpful.

Elias, Stephen; Renauer, Albin; Leonard, Robin; and Michon, Kathleen, *How to File for Chapter 7 Bankruptcy*, (Nolo Press, 15th edition, 2008). A complete and updated reference for consumers who are seriously considering filing for Chapter 7 bankruptcy. It explains each step of the process, and includes tables that list federal and state property exemptions, as well as all forms necessary to file for bankruptcy.

Leonard, Robin, *Solve Your Money Troubles: Get Debt Collectors Off Your Back & Regain Financial Freedom*, (Nolo Press, 11th edition, 2007). A guide for overextended consumers who are dealing with such matters as debt consolidation, loan restructuring, and collection agencies. It includes sample letters to creditors and an overview of the bankruptcy process.

AIER has a number of books that can help make wise credit and financial decisions:

Homeowner or Tenant? How to Make a Wise Choice explains the considerations involved in owning a house versus renting;

How to Avoid Financial Tangles covers a wide array of financial issues, including property ownership, taxes, insurance, debt, mortgages and investments;

How to Avoid Financial Fraud provides advice on how to avoid becoming a victim of identity theft or of unscrupulous speculators, financial planners, or brokers;

The Rubber Budget Account Book is designed to help a family to track its expenses and live within financial means so as not to get in debt in the first place.

Other Resources

Government publications

The Federal Reserve provides useful information to consumers at http://www.federalreserve.gov/consumerinfo/. The topics covered include personal finance, consumer credit, mortgages, identity theft and others.

The Federal Trade Commission offers a wealth of useful information through its Bureau of Consumer Protection, which can be accessed at http://www.ftc.gov/bcp/. The information includes explanation of the relevant consumer protection legislation: The Fair Credit Reporting Act, the Fair Credit Billing Act, and the Fair Debt Collection Practices Act.

The website also offers booklets (available electronically and through the mail) covering many of the topics in this book, such as "Credit and Your Consumer Rights," "Fiscal Fitness: Choosing a Credit Counselor," "Credit Repair: How to DIY and Avoid a Scam," "Secured Credit Card Marketing Scams," "Avoiding Credit and Charge Card Fraud," and "Choosing A Credit Card: The Deal is in the Disclosures." For more information or to receive free copies of these publications, visit the FTC's website (http://www.ftc.gov/bcp/consumer.shtm), call 1-877-FTC-HELP (1-877-382-4357), or write to the Federal Trade Commission's Consumer Response Center, 600 Pennsylvania, NW, Washington, D.C. 20580-0001.

A dedicated webpage maintained by the Federal Trade Commission explains how to obtain a free credit report: http://www.ftc.gov/freereports/.

The U.S. Department of Education has a toll-free hotline (1-800-4-FED-AID; 1-(800) 433-3243) for questions about federal student loans. You can order a copy of the free booklet, *The Student Guide: Financial Aid From the United States Department of Education* from the hotline or by writing to the Federal Student Aid Information Center, P.O. Box 84, Washington, D.C. 20044.

Non-governmental resources

Each of the three nationwide credit bureaus maintains a webpage with educational information on credit, tips for preventing fraud and identity theft, forms for reporting disputed items on a credit report, and other helpful information. These pages for each credit bureau can be found at:

Equifax—http://www.equifax.com/credit-information/

Experian—http://www.experian.com/consumer/credit_education.html

TransUnion— http://www.transunion.com/corporate/personal/consumer-Support/consumerResources.page

Another resource is the Bank Rate Monitor (www.bankrate.com; (561) 630-2400). Look for the credit card locator in the credit card section of this comprehensive website about bank loans and bank products. The locator sorts credit card deals by interest rates, fees, and rebates. Online booklets are also helpful. These include “Guide to Managing Credit” (found at http://www.bankrate.com/brm/news/credit-management/debt-home.asp) and “Guide to Financial Literacy” (found at http://www.bankrate.com/brm/news/Financial_Literacy/Financial_Literacy_toc_a1.asp). The site also has information on mortgages, home equity loans, and auto loans.

FinAid (www.finaid.org) offers information on student loans, scholarships, and college savings plans.

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What You Need to Know About Mutual Funds
What Your Car Really Costs: How to Keep a Financially Safe Driving Record

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Prospects for a Resumption of the Gold Standard

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Prospects for Reforming the IMF and the World Bank
Reconstruction of Economics
The United States Constitution: From Limited Government to Leviathan

Ours is a credit society.

But this powerful (and often necessary) tool for buying everything from houses to hot cakes also can create serious problems.

As the mortgage meltdown of 2007-08 has proved, unwise credit decisions can have dire consequences for individuals, businesses, and entire economies.

This updated edition of AIER's classic guide to the world of consumer credit includes specific steps anyone can follow to enjoy the benefits of borrowing—and avoid the pitfalls.

Research fellow **Polina Vlasenko** holds a doctoral degree in economics from the University of Maryland, College Park. Her research interests include money and banking, financial institutions, macroeconomics, and economic policy. She has taught undergraduate and graduate courses on these subjects both in the United States and abroad.

ISBN 978-091361065-7
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