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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

Last year was the first year in which Medicare collected less in taxes than it paid out in benefits. And its trustees now project that it would exhaust its trust fund no later than 2019.

Fitch Ratings downgraded 14.5% of investment grade U.S. bond market volume in the first quarter while upgrades affected only 0.3% of volume.

Credit Cards and the Consumer

According to the latest data from the Federal Reserve, Americans today carry an aggregate credit card balance of about $945 billion – about 7% of the country's annual output. 46% of American families do not pay off their credit cards each month. Credit card debt is both a consumer problem and also a key element in maintaining robust consumption in the US economy.

Now, many consumers are facing mounting credit card bills at the same time that their incomes are falling. Fitch Ratings tracks credit card delinquency - credit card debt more than 60 days late. In April 2009, this measure rose to its highest level of 4.44% since the index was constituted in 1991.

There are numerous consumer issues related to credit cards. This article will discuss the existing rights of cardholders as well as enhancements being considered by congress and federal regulators. There are also important financial planning issues related to the effective management of credit card debt. Those will be covered here as well.

The Consumer's Existing Rights

There is already a body of law in place to protect the consumer against certain issuer practices and negative events. First of all, credit card issuers may not deny credit on the base of race, sex, marital status, religion, age, or national origin. If you are denied a credit card, you must be told why.

Under Federal Law, the consumer is liable for no more than $50 in unauthorized charges. Most credit card companies will not hold cardholders liable for any unauthorized charges provided the consumer notifies them promptly in the event that a card is lost or stolen.

A credit card company is required to provide written notice when it changes any term in the card agreement. Read these changes carefully as they might negatively impact you, particularly when they change the way your interest is computed. You can reject the proposed changes to your credit card agreement and use your card under the old terms until your annual membership expires.

Complaints against credit card companies can be filed online with both the Federal Trade Commission [www.ftc.gov] or the state attorney general's office. Generally, you will get better results complaining to your state AG office than with the FTC. Most AG offices investigate every single complaint.

The Federal Reserve and Congress Step in

The recession has jeopardized the credit standing of millions of consumers. Credit card delinquencies and write offs are at all time highs. This has created political waves. Both federal regulators and Congress are preparing to expand the consumer's rights regarding credit card debt. This past December, the Federal Reserve announced that new rules governing credit card agreements would go into effect on July 1st, 2010.

Here are some of the regulatory measures that credit card issuers must comply with by next July.

- Credit card companies cannot raise interest rates on consumers unless they were late on a payment.
- Issuers cannot eliminate the interest-free period for consumers who move from paying the full balance monthly to carrying a balance – "double cycle billing"
- Lenders must apply payments to balances with the highest interest rates first
- Lenders cannot increase a consumer's rate based on late payments to another lender - "universal default."

Both branches of congress have passed or are drafting bills that elevate these regulations to a consumer " bill of rights". It is possible that President Obama will sign a bill that compels the measures above before July 2010.

Of course, there is a downside to expanded consumer rights. As card issuers are given less freedom to charge higher prices to riskier borrowers, they will be compelled to charge higher prices to everyone. Prospective credit card holders may be denied credit because card issuers have fewer tools available to price risk efficiently. The American Bankers Association has therefore weighed in against congressional efforts to expand cardholders "bill of rights".

Financial Planning and Credit Card Debt

Apart from knowing your basic rights, it is important to use credit cards wisely. Almost 50% of American families are carrying credit card balances. Usually this debt is the most expensive to service. Other forms of debt such as a home mortgage or a car loan are collateralized with assets – thus the cost of these loans is lower.

Most clients are asked to list the sources of debt in a financial planning consultation. The idea is to establish priorities for early payback. The high interest rates and penalties of credit cards invite intervention. Every dollar used to pay down a credit card balance with 8% interest effectively earns 8% in that interest charges are reduced at that rate. Money market yields today are less than 1.50%. The best use for the excess cash is mathematically obvious.

Another reason to reduce credit card balances is the collateral damage they can do to a consumer's credit. Credit card balances in excess of 30% of the stated limit will reduce a borrower's credit score. It's also important to pay substantially more than the minimum payment as repeated minimum outlays are a red flag.

Are there exceptions to the general rule of paying down credit card balances? Certainly. Reducing debt is important but so is having access to an emergency fund that can cover several months of expenses. The recession and the pending credit regulations are making credit companies quite cautious about extending new credit. Reducing one's balance might simply invite a reduction in one's credit limit. It might not be possible to grow the balance again. Some families may not have access to credit in the event of a job loss or sudden expense.

For families without an emergency fund, we generally recommend that they accord cash reserves and debt reduction a similar priority. In other words, excess cash flow can be allocated simultaneously to debt reduction and cash reserves. The graphic below illustrates how a cash flow surplus can be devoted to multiple uses.

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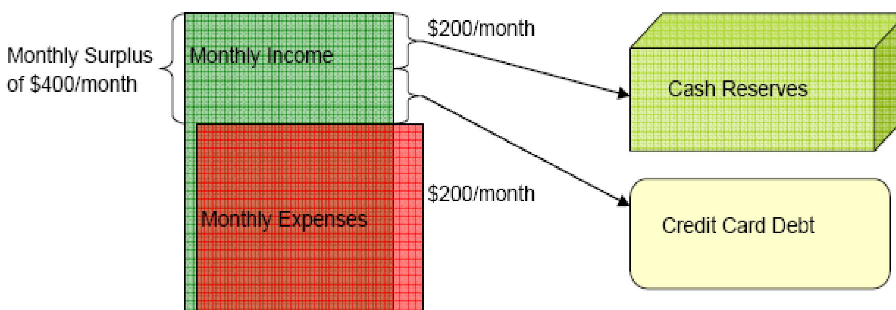

Credit cards are, of course, not the best source of liquidity. For families with with substantial equity in their house, a home equity line of credit (HELOC) is a superior option to a credit card. The interest rates are substantially lower and the interest charges can be tax deductible. There is typically no charge to apply for a HELOC. Once in place, the borrower can pay off credit card balances with comparatively efficient debt secured by an asset. Currently, the rates on HELOCs for good credit borrowers are between 2.75% and 4.25%

For those without access to home equity, more formal forms of debt consolidation may be in order. Third parties can be of help. Debt relief agencies offer three key services:

Credit Counseling. Advice on how to create a budget, pay down debt and start building an emergency fund.

Debt Management. These programs help consumers fully repay their debts, typically over a 5 year period, by negotiating with creditors to reduce interest rates

Debt Settlement. Help consumers negotiate with creditors to pay less than they owe.

It's important to note that the debt relief industry is lightly regulated. The number of debt relief agencies has more than doubled in the past two years. Both the FTC and the state attorneys general have been bombarded with complaints.

Many creditors, such as American Express, say that they do not work with third party agencies. Their policy is to work directly with the borrower. Indeed, borrowers may be able to cut a better deal for themselves in bypassing the agencies. The Texas AG's office recommends the following steps to anyone considering third party debt relief:

- Talk to an attorney knowledgeable about credit and learn about the legal consequences of stopping payments to creditors. Do this **before** engaging a credit relief agency.
- Be wary of companies that guarantee results and promise you that your credit will not be negatively affected by entering into a debt settlement program. Debt settlement almost always has a negative effect on a credit score.
- Demand to know in advance all fees a debt settlement company will charge you for their services, above and beyond amounts to be paid to creditors, and get this in writing. Be especially wary about large up front fees.