Fundamentals of Money Management

Debt Management – Credit Cards

April 28, 2014 by Guest Commentary

OPINION – In today's financial world we live on either a cash flow or credit basis. Living within your cash flow needs is always best because you are not trying to live beyond your means. Living on a credit basis can be a significant issue when faced with an emergency, a lifestyle change or any other catastrophic event that prevents you from making payments on outstanding debt. Although is it is difficult to avoid using credit, there is a happy medium that one can live with if they use a commonsense approach and financial knowledge to guide you through uncertain times.

The best way to avoid a credit catastrophe is to understand the advantages and disadvantages of using credit cards that make up part of the debt industry.

Advantages of Credit Cards

A credit card can be used in combination with other identification to establish who you are.

Credit card records can assist in record keeping for managing personal or business expenses.

Having a credit card allows you the ability to make long distant purchases (such as on-line, national and international transactions).

With a credit card, one can easily return purchased items because of electronic billing that can be traced and recovered.

In very rare occurrences (buyer beware), some establishments will offer free credit. Just make sure you read the small print in the contract to ensure interest is not added on to the total invoice.

Many credit cards offer other advantages, like travel insurance or frequent flier mileage. These are also called loyalty points.

Benefits of having a credit card helps:

- Build Credit (increases your FICO Score)
- Assists you in emergencies
- Act as a cash proxy when you do not have money in your pocket.

Disadvantages of Credit Cards

If you cannot pay for things in cash, a credit card is the best, but most expensive way to borrow cash until you pay it off.

There can be bad effects of living on credit cards:

- Impact on your credit (FICO) score – too many credit cards can hurt your credit score especially, if you have large balances on them.
- Overspending: You can get into the habit of overspending on things that you want but do not need.
- Long term costs of paying interest on credit cards may take you a very long time to get out of debt.
- Debt overload can become a problem when you cannot pay all of your bills on time. Creditors and collection agents start coming after you. In some cases, collectors can garnish your wages. Think of it this way: what if you got your check and half of it was taken by a creditor before you got it.
- You will not be able to reach long term financial goals when you are spending money on bills you cannot afford to pay.

Loss of privacy: Your credit card usage is a source of public information. Many corporations track your spending habits and, in some cases know, what you are going to purchase before you do. This creates a

whole new problem: With all of your personal business and credit information out in the public, one can easily become a victim of fraud & identity theft. A secondary point is that everyone looks at your credit. It is used in renting an apartment or house. Employers evaluate credit in hiring for jobs. Colleges are looking at credit for admission to professional schools like medical or law.

The first thing to consider when applying for credit is the Five C's of Credit.

- Character – Believe it or not, your employment and education plays a big factor in getting credit. There is the perception that a well-educated person will be more reliable in terms of repayment of debt. Also, a person who stays on one job for a long time is viewed better than a person who has lots of jobs over short periods of time. Thus, it pays to stay in school and to stay on one job for at least a year or two.
- Capacity – A Creditor or Lenders' assessment of your ability or capacity to repay your debts such as your income, your job status and your prior history of credit (if you have any).
- Capital – Creditors or Lenders are interested in your household net worth; what are your assets compared to your liabilities (savings versus bills)?.
- Conditions – Economic conditions are unique to every borrower. You should provide full disclosure on events in your life that have created credit problems in the past. In today's complex world, security and background checks are the new normal. If you have issues with your past, the creditor will find out. It is best to disclose the bad news up front explaining how you have overcome those issues.
- Collateral – What are the material things you own that can be converted to cash to pay a creditor or lender? A loan protected by collateral is safer than one that is not. Examples: car loan – if you do not pay, they repossess the car. House note: if you do not pay your mortgage, the banks will foreclose and take back the house

Picking the Right Credit Card

Once a decision is made to apply for a credit card, consider the following:

- Services: What types of services does the card provide above and beyond purchasing items?
- Do they have concierge services that provide information on how best to use your card?
- What types of things does the card allow you to purchase: small household items like groceries to big ticket items like furniture?
- Annual fee: Does the card charge an annual fee for having it? Some cards charge a membership fee that ranges from $30.00 to $300.00 each year.
- Loyalty programs (points): Does the card allow you to gain points to obtain free items later on such as free up-grades on airline tickets, or personal goods or services.
- Rate, Fee and Other Cost Information: Most cards have a variety of interest rates (fees) based on the use of the card.

1. Annual Percent Rate (APR) – The annual interest rate during the billing cycle that ranges from 10% to 29.99%.
2. Other APR's include Balance Transfers (transferring one credit card account to another credit card account) ranges from 14% to 28%.
3. Cash advances – 25%.
4. Late payments 27.99% to 29.99%.
5. Overdraft protection – Prime Rate+15.99% (the prime rate is the rate banks give to their best customers).
6. Long Grace Periods – From the time you get the bill to the time you pay it; before it is late (ranges from 7 days to 20 days).
7. Minimum Finance Charge – The minimum charge for a transaction ($1.00 to $3.00).

8. Transaction Fee for Balance Transfers – Above the amount in Balance Transfer (#1 above) will be 2% to 3% per transaction not to exceed a dollar amount (Example: $50.00).
9. Transaction Fee for Cash Advances – Above #1 above.
10. Late Payments (a fee) – Above and beyond #1 above can be a dollar value for the amount of the bill (example: $15.00 for a balance of $150.00 or less, $28.00 on balances above $150.00 and up to $34.00 on balances over $1,200.00).
11. Over the Credit Limit fee is normally a flat fee of $15.00 or more. This is an area that you need to be careful. If you are late, the company may lower your credit limit which in some cases will automatically put your current balance over the limit and you will get hit with this fee.

Reputable companies: Make sure the company is a reputable and well-known company that provides full disclosure of the do's and don'ts in using their card.

Always Read the Fine Print on the back of the application and always call and ask questions. If you do not get a quick response for an inquiry, you may want to reconsider using that particular card.

Types of Consumer Credit Cards

- Closed-end credit – This is credit for a specific company to be paid back with interest (Macy's, Costco & etc.).
- Open-end credit – Also called Revolving Credit. You are given a credit limit to use at any time, any place and anywhere the card is accepted (Visa, M/C, AmEx, Discover).

Types of Credit Cards

- Bank Cards: Bank cards allow the holder to make purchases anywhere, place or time the card is accepted.
- Retail Cards (closed end): Cards that are used in one particular store (i.e. Macy's & etc.).
- Travel & Entertainment Cards (closed end): Cards designed to allow customer to pay expenses in line with company reimbursement programs.
- Debt Cards: A card that is used in lieu of checks where the funds come directly from a checking account.
- Unsecured – While credit cards are, for the most part, not secured by collateral, they carry the most in penalties if not used wisely.

What happens if you are denied credit?

If you apply for credit and are denied, you have the right to know why. Most lenders deny credit for the following reasons:

- Adverse information in your credit report
- Insufficient income relative to expenses
- Insufficient collateral
- Insufficient job history
- Insufficient residency at current address

When used in a comprehensive financial management plan, credit cards can improve your quality of life. But if not used properly, it will ruin your life. Our next article will be on "Investments Saving and You!

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