CHAPTER TEN

Something Borrowed

Consumer Credit

THE USE OF CREDIT is as American as apple pie. Americans routinely borrow money to buy, over time, homes, cars, appliances, clothing, vacations, and other goods and services. Frequently, credit is available from the seller. A great deal of credit is sales credit, including automobile credit, retailers' cards, etc., and credit on bank credit cards--except for cash advances-- is usually sales credit too. It may be subject to some different legal rules, but for the most part this chapter will ignore such refinements and concentrate on generally applicable laws.

On average, about 11 percent of a family's after-tax income is absorbed by payments for consumer installment debts. There are three basic forms of consumer credit.

- In an **installment credit agreement**, a consumer signs a contract to repay a fixed amount of credit in equal payments over a specific period of time. Automobiles, furniture, and major appliances are often purchased on an installment basis. Personal loans are usually repaid in installments as well.
- In a **revolving credit agreement**, sometimes referred to as an **open-end credit agreement**, a consumer has the option of paying in full each month or of making a specified minimum payment based on the amount of the balance outstanding. Department stores, gas and oil companies, and banks typically issue credit cards based on a revolving credit. Visa

and MasterCard, typically issued by banks, are examples of this type of credit.

- In an **open 30-day agreement,** sometimes called a **non-installment credit agreement**, a consumer promises to repay the full balance owed each month. This is old-fashioned "charge account" credit, which is rapidly disappearing. Travel-and-entertainment charge cards, such as American Express and Diners Club, as well as charge accounts with local businesses, may require that the full balance be paid on this basis.

The extension of credit is a service for which lenders, or **creditors**, charge money, which of course is called **interest** or **finance charge**. Interest represents the Aprice of money,@ and is based on an amount representing a premium over what the lender could have made if the lender had invested the money, known as the **principal**, rather than lent it to you, plus the nuts-and-bolts cost of providing the credit. Interest can also be looked at as the amount you are willing to pay in order to have something now instead of later.

THE COST OF CREDIT

Many states regulate the amount of interest, or the **rate**. Most, particularly if the credit is extended by the seller, leave it entirely, or practically, to the market. That means it is up to you to shop for the best rate and credit terms, a task made easier by the Truth in Lending Act (TILA). TILA requires that all creditors provide information that will help you decide whether to buy on credit or borrow and, if so, which credit offer is best for you.

Under TILA, before you sign a contract for credit, creditors must disclose to you in writing, among other information, the following:

- the amount being financed;
- the number of monthly payments required; and
- the critical Annual Percentage Rate (APR).

The APR is an annual rate that relates the total finance charge to (1) the amount of credit that you receive and (2) the length of time you have to repay it. Think of the APR as a price per pound, like 20 cents per pound for potatoes. You can buy five pounds for one dollar or ten pounds for two dollars -- either way the cost per pound, or rate, is the same and the amount you spend depends on how many spuds you buy. When you Abuy credit,@ you buy a certain amount of credit for a number of months. The total dollar amount of your finance charge will depend upon how many dollars worth of credit you obtain initially and how many months you use those dollars.

TILA also regulates credit advertising, which makes it easy to credit-shop. For example, if an automobile ad emphasizes a low monthly payment (giving a dollar figure), it also must tell you other pertinent information, like the APR.

The APR must always be considered in terms of the length of the loan. As noted in the chapter on automobiles, if you can only afford $100 a month for a car, you might have to take a longer-term loan to get the payment down to that figure. Just be aware that at the end of the loan period, your **total finance charge** -- the total amount of money youFve paid just in interest -- would be higher than if you'd taken out a shorter loan. The choice of stretching out the loan is one you may rationally choose to make--but watch out for balloons where the creditor sets initial payments low but the last payment is a whopper! In a stable interest rate environment such as has existed over the last few years, balloon mortgages are usually not a great idea.

There are other factors as well. Auto dealers, for example, frequently offer "incentive financing" with very low APRs or cash rebates. Often you can save money by skipping the low rate and applying the cash value of the financing deal to the amount you would have financed. (You might save even more by getting financing from someone other than the dealer.) By reducing the principal, even with a higher interest rate you might end up with lower monthly payments for the same length loan and, at the end of the term, a lower finance charge. Similarly, taking the cash may make shortening the term of the loan attractive.

SIDEBAR: Tax deductibility

Under current tax laws, almost all homeowners have the option of deducting all their mortgage interest from their taxable income for tax purposes. Thus, from a tax standpoint, it often makes sense for those who own property and itemize deductions to refinance their installment and revolving credit -- which is not deductible -- by taking out a second mortgage (a lump sum) or a home equity loan (a line of credit). Tax advantages notwithstanding, this is not a step to be taken lightly. If you can't pay back the money, you'll risk losing your home. When you take out a second mortgage or a home equity line, you are allowing another lien to be placed on your home. (You granted a lien when you took out your first mortgage.) While you home is the last thing an unsecured creditor can look to in satisfying, say, nonpayment on a credit card debt, or may not be looked to at all, nonpayment on a home equity loan can easily lead to the loss of your home.

CHOOSING A CREDIT CARD

Many of us are bombarded with solicitations for credit cards such as MasterCard, Visa, Discover, and Optima, which are actually issued by banks, savings and loans, credit unions, and other companies but are part of a cooperative network. Basically, these banks and other institutions are asking you to borrow money from them, assuming that you will use the cards= credit lines rather than pay off your balance in full. (The card issuers get a small return on every purchase, paid by the merchant, regardless of how you pay your bill.)

Selecting a credit card is like selecting a suit or dress; you want a good Afit.@ Because there are many card issuers, you have a wide choice among cards. In this section, we will examine terms that are typically offered to consumers by banks and other issuers of credit cards. It is illegal for card issuers to send you an actual credit card unless you have asked for it. Every solicitation must include a brief disclosure statement under the TILA. Any offer to extend credit that doesn=t have full disclosure that=s easy to find has something to hide. Put it in the recycling bin.)

This TILA disclosure statement must tell you the card=s APR and, just as importantly, how the credit grantor figures it. This depends on how you use the account and how payments are applied. A common system is to apply the APR to the **average daily balance** in your account over the billing period. Some retailer credit cards compute the balance by subtracting payments made or credits given during the billing period from the total amount you owe; this is called the **adjusted balance** method. A very few credit grantors still use the **previous balance** method. They do not subtract from the balance any payments made during the billing period, but apply it at the end. These little details can amount to a lot of money in the medium run, but it is hard to tell which is best without seeing how each system works with your account activity. (The previous balance method tends to be most costly to consumers.)

Many credit cards offer a 20- to 25-day **grace period** for purchases. This is the time between the end of the billing cycle and the date by which you must pay the entire bill to avoid paying any finance charge. The grace period rarely applies to cash advances on your credit card, and if it does it probably has a very costly upfront fee. The credit grantor may adjust the grace period under another method of assessing monthly charges on your bill called the **retroactive** or two-cycle balance method. Under this system, if your opening balance on your bill was zero, and you then made credit purchases but did not pay your entire bill, your next monthly bill will include a finance charge for these purchases from the dates that they were posted to your account. Look closely at the disclosure statement or cardholder agreement to see if it uses the retroactive method. The retroactive balance system is not meant for your benefit, but if you usually don't pay your balance in full and continue to revolve there is little difference between the retro system and the average daily balance.

The APR can change on a credit card if there is a **variable-rate provision**. More and more credit card issuers set APR's that vary with some interest-rate index, such as the market rates on three-year U.S. Treasury bills or the prime rate charged by banks on short-term business loans. These issuers must disclose in their solicitation to you that the rate may vary and how the rate is determined. This may be done by showing the index and the **spread**. The spread is the number of percentage points added to the index to determine the rate you will pay. Thus you will frequently see disclosures such as this:

Variable Rate Information

Your Annual Percentage Rate may vary quarterly. The rate will be the Prime Rate as published in the Wall Street Journal plus 9%. The rate will not go below 15.0% or exceed 19.9%.

Many new offers these days have "teaser rates," such as a low rate effective for six month, at which point the prime plus 9% takes over. Pay attention to how long the period lasts in which you get the low rate.

Additional Fees

Your disclosure statement may refer to various fees. These include:

- **Transaction fees for cash advances.** These are typically in the neighborhood of 2% of the amount of the advance, with a minimum of several dollars. They should be capped at $10 or, at the most, $25, though not all are.
- **Late-payment fees.** You should not be planning to pay late. Many card issuers were once generous in this regard and did not impose the late fee every time or only after a grace period, such as ten days. To a large extent, as profit margins have shrunk in the credit card

business, this forbearance is no longer available, or if it is you can get it only once. Fees of $15 to $30 are typical. Also note that late payments are a default that can lead to cancellation of the card.

- **Over-the-limit fees**. These bear watching, since a perfectly innocent mistake can result in your going above your pre-set credit limit. Again, doing so can be a default.
- **Replacement card fees.** If it is more than nominal, this may not be a reasonable fee. Watch out for the provider who sticks you with a big fee in the agreement -- there might be more surprises in there.

Annual Fees

Whereas few, if any, credit cards issued by retailers have annual fees, many credit cards issue by financial institutions do. These fees, which must also be in the TILA disclosure, typically range from $15 to $25, or higher for "gold" or "platinum" cards. In the present competitive environment, you don't have to pay an annual fee, considering how many free cards there are out there. But it might make sense to do so in some situations. For example, it might be important to you that a card provides separate benefits, such as airline miles. Another reason is that you do not pay off your balance in full each month and can get a lower APR with a card that charges a fee. What it boils down to is that you have to decide at the outset whether you will pay off the balance each month or will typically carry a balance each month. Those who revolve should shop for a card with a low rate, even if it carries an annual fee. Those who really will pay of the balance each month or the great majority of months should shop for a low-fee or no-fee card.

Issuers make their money one way or another; if it's not on interest, it will be on fees. Thus charge cards such as American Express and Diners Club, and other "premium cards" with very high lines of credit, or no pre-set spending limits, charge $35 to $75. Consumers will have to decide for themselves whether the "prestige" of carrying such a card, and the various additional benefits they provide that are mostly helpful to business users, is worth the fee.

-------------SIDEBAR: Secured credit cards

Some people whose credit ratings aren=t good enough to merit a credit card want the convenience of cash-free living enough to pay for a **secured credit cards**. This is a credit card secured by a savings account on deposit with the issuer. The line of credit is usually limited to the amount on deposit or a little less. Watch for high APRs and fees on these cards, which are sometimes the refuge of the credit-desperate. Don=t apply for any card that requires an application fee, or that requires a call on a A900@ number to apply. And avoid like the plague the ones that only work with catalogs provided by the issuer. That=s not what you want the card for.

Having a secured card may be compared to using training wheels in a bike. After a year or so on your secured card, your demonstration of responsible use of credit may merit you a regular credit card. Look for cards that promise that you can convert to an unsecured card after a year.

APPLYING FOR CREDIT

When you apply for credit, there are legal rules to make sure that your application is handled fairly and confidentially. The federal Equal Credit Opportunity Act (ECOA) prohibits credit grantors from considering race, color, national origin, sex, marital status, age, your receipt of public aid, or your exercise of your legal rights as a credit-seeker in connection with your application, or in setting the terms of credit actually granted you. As to age, once you have reached the age of majority (18 or 21, depending on the state), credit grantors generally may not use your age against you -- whether youth or old age -- in determining your creditworthiness. It may, however, consider the future of your income stream if you are at or nearing retirement, though it may not require you to buy life insurance to qualify for credit or cancel your credit on your retirement.

Credit grantors may generally use any of the following factors to decide whether to extend credit to you and at what terms:

- **Ability to repay.** This depends on the stability of your current job or income source, how much you earn, and the length of time you have worked or will receive income. Credit grantors also may consider your basic expenses, such as payments on rent, mortgages or other debts, utilities, college expenses and taxes. This analysis is typically done by mortgage lenders, rather than companies that grant consumer installment credit.
- **Credit history.** This shows how much money you owe and whether you have large, unused lines of open-end credit. A very important consideration is whether you have paid your bills on time and whether you have filed for bankruptcy within the past ten years or had

repossessions or judgments issued against you.

- **Stability.** Your stability is indicated by how long you have lived at your current or former address and how long you have been with your current or former employer. Owning a home is normally a big plus.
- **Assets.** Assets such as a car may be useful as collateral for a loan. Credit grantors may also look at what else you may use for collateral, such as savings accounts or securities, though this kind of analysis is found more often in business loans than in the typical application for consumer credit.

The Equal Credit Opportunity Act requires that the credit grantor notify you of whether it will accept or reject your application within 30 days of receiving it. If your application for credit is denied, the denial must be in writing and must give the reasons or allow you to request the reasons. And under the Fair Credit Reporting Act, in the event of a credit denial (or withdrawal or reduction), the grantor must tell you if it based the denial on your credit report and, if so, the name of the reporting agency that prepared the report and how to reach them. If you think you have been denied credit for illegally discriminatory reasons, and cannot resolve the problem with the institution, you may want to consult a lawyer. The Equal Credit Opportunity Act allows for punitive damages in addition to any losses you can prove you suffered as a result of such activity.

Credit Records

Just as it is frustrating to apply for your first job when they all say they want someone with experience, applying for your first loan or credit line without a credit history seems hopeless. You do need a credit record, even if you are married and your spouse handles Aall that stuff.@ You spouse could mishandle "that stuff" and tarnish your name, or your spouse could mishandle something else and become your ex-spouse. Especially if you have your own income, open an account or two in your own name and use it (wisely!) from time to time.

There are ways to build a good credit history. Start by opening and maintaining checking and credit accounts. The next step is applying for a credit card from a local department store (it should be one of the national ones, since many smaller credit-grantors and gasoline cards do not report to credit agencies) -- and using it. Another option is to have someone who does have a credit rating, such as a parent or spouse, co-sign the loan with you. (It should be someone close, since a co-signer is fully liable on the loan.) Once you pay it back, you have, as in all these techniques, shown that you can do it. You can also try to see if you can borrow against money in your account at a bank or credit union, or get a secured credit card.

You should also know about credit bureaus, or credit reporting agencies, which keep computerized records of your financial payment histories, public record data (liens, lawsuits and the like), and personal identifying data. (These agencies do not have medical information.) There are three main credit reporting services, though they may operate under other names in some communities: Experian, Equifax Credit Information Services, and TransUnion Credit Information Company. They are regulated by federal law and in some states by state law.

These credit bureaus do not issue a Acredit rating@ *per se*, nor do they make credit decisions. They just provide information as reported to them by credit grantors. The information is not provided to just anyone but is legally restricted to persons or organizations with a legitimate business need for it (In applying for credit, you usually give permission to the issuing company to obtain a report; you may also be asked to give permission when you apply for a lease or even a job.) Because the reports filed by credit bureaus have so much influence over your financial future, be sure the information you use to apply for credit is consistent. Decide on the form of your name to use and stick with it. Don=t be shy about giving your social security number when you apply for credit -- it=s the best way to identify you and assure your data isn=t mixed in with someone else=s.

You can also see your credit report. If you are denied credit on the basis of your credit report, you are entitled to a free report from the bureau used by the credit grantor within 30 days of the denial. Thanks to laws in some states and the voluntary policies of some credit bureaus, it may be free in other situations as well. In any event, you shouldn't have to pay more than a nominal fee even if you are required to pay. All three major credit bureaus as well as many of the smaller ones have websites that make it easier to find out more about what they have found out about you.

You are also entitled to know the identity of every creditor reporting to the agency on you and everyone who has gotten a copy of the report in the last six months. If you dispute the correctness of any information on the report, the FCRA requires the agency, if your dispute is Anon-frivolous,@ to verify or delete the information. If there is a sticking point with a certain creditor, you may be able to get the creditor to agree to set the record straight; if there is a good reason for the problem that occurred, and you have since settled matters, they should be glad to help. The credit agency will automatically notify the other bureaus of any change and, if you wish, notify any creditor that has checked your files in the last six months. Thus you can fix most problems without the help of expensive Acredit-repair clinics@ with their pie-in-the-sky promises and high-as-the-sky fees. (In contrast, credit counseling services, which help consumers figure a way out of deep credit holes, are often useful and affordable. You can get more information about nonprofit agencies from the National Foundation for Consumer Credit, at 800-338-2227.)

How long does it take for a bad credit experience to fade away? Normally, most negative information may not legally be reported after seven years, but may be made available if you are applying for at least $50,000 worth of credit, life insurance with a face value in at least that amount, or a job paying more than $20,000 a year. And bankruptcies stay on the report for ten years.

DEBT COLLECTION

Besides harming your credit record, delinquencies (failure to pay debts on time) can cause you to end up in court. In some states, a successful lawsuit by a creditor could result in a **garnishment** of your wages, especially if you have a decent income. That means your employer is ordered to pay part of your salary to the creditor until the debt is paid off.

A car, truck, large appliance or other durable good purchased with credit may have a lien on it, and be subject to repossession for non-payment. Some states require advance notice before the creditor can **repossess** (come to take its stuff back). Remember that all credit agreements contain **acceleration clauses**, which say that if you are in default, the entire debt, not just the monthly payment or payments you missed, is due immediately. And if repossession and resale of the property does not satisfy the whole debt -- which may be swollen by finance charges, late fees and repossession costs -- you are still on the hook for the deficiency (unless state law prohibits a deficiency, as some do in some cases).

The Fair Debt Collection Practices Act (FDCPA) regulates professional debt collectors who work as outside agents for creditors. It does not regulate creditors themselves, though many states have laws that do. Under the federal act, a debt collector may only contact you by mail, in person, or by telephone or telegram during convenient hours. Unless you agree in writing (or a court grants permission), a collector may not contact you at inconvenient times or places, such as before 8:00 a.m. or after 9:00 p.m. Also, a debt collector is not permitted to contact you at work if the collector knows or has reason to know that your employer forbids employees from being contacted by collectors at work. You can tell the debt collector what times and places are inconvenient for you to receive calls.

A debt collector is not allowed to contact you if the collector knows you have a lawyer handling the matter. And the collector must leave you alone if you instruct the collector, *by mail*, to do so. Once you do that, the collector may only confirm that there will be no further contact, and that some specific legal action may be or will be taken (and only if they mean it). A collector must also leave you alone if you notify the collector in writing during the first 30 days after you are contacted that you dispute all or part of the debt, unless the collector provides proof of the debt.

Within five days of your first contact, a debt collector must send you a written notice stating:

- the name of the credit grantor to whom you owe the money;
- the amount you owe;
- that the debt collector will assume the debt is genuine unless you challenge all or part of it within thirty days, and what to do if you believe you do not owe the money;
- that if you ask for it, the debt collector will tell you the name and address of the original creditor, if different from the current creditor.

A debt collector may contact anyone needed to locate you, but may not speak to anyone more than once nor mention the fact of the debt. (That includes mailing an otherwise innocuous letter in an envelope indicating it comes from a bill collector.) A collector certainly may not, under the law, harass, oppress or abuse anyone. Specifically, a debt collector may not:

- threaten violence to you, your property or your reputation;
- use obscene or profane language;
- annoy you with repeated phone calls;
- make you accept collect phone calls or telegrams;
- publish your name on a public roster of Adeadbeats@;
- misrepresent the amount of the debt;
- falsely imply that the collector is a lawyer; or
- threaten legal action that the collector does not intend to take or that is not available.

Debt collectors who violate these rules are subject to be sued for civil penalties the

Federal Trade Commission in Washington, which is particularly active in this area. You can also sue in federal or state court under the Fair Debt Collection Practices Act, if you act within a year of the offense. You may recover your losses plus up to a thousand dollars per violation -- but are subject to paying the other side's attorneys' fees and court costs if your own suit is undertaken in bad faith.

If a retailer, bank or other credit grantor misbehaves in collecting a debt, check with your state's consumer protection office or attorney general's office and see if help is available. (A letter to these agencies, with a copy to the offending credit granter, may go a long way.)

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