

Tips and Tools Series

Managing Credit Card Debt

Introduction

In 2008, the average household owed nearly \$11,000 in credit card debt. Interest rates on credit card debt average 13.54% but can be as high as 22.75%.

Most AFI-funded IDA projects find that their participants are attempting to deal with consumer debt issues. In many cases, the debt includes credit card debt.

Credit card debt is one of the fastest growing areas of debt in the United States. In 2008, the average household owed nearly \$11,000 in credit card debt, a 29 percent increase from 2000.¹

One reason for this increase is that credit cards have become relatively easy to get and use. Unfortunately, this ease has come with a cost. Currently, the average annual interest rate for credit cards is 13.54 percent. However, annual percentage rates can be as high as 22.75



percent.² People who have poor credit histories, low credit scores, and few financial resources often pay the highest annual interest rates for the charges they make on a credit card.

This installment of the Tips and Tools series provides information for staff of AFI-funded IDA projects and other IDA projects who are working with individuals and families who need to pay down credit card debt. The Tips and Tools features a discussion of different types of debt, how credit card debt affects IDA project participants, and how IDA projects can help prospective and current participants manage credit card debt. The Tips and Tools includes a handout with advice for staff that are helping their IDA project participants manage debt; a tip sheet to share with participants; and a worksheet that participants can use to organize their credit card debt and make a credit card debt management plan.

As long as unsecured debt is part of a household's financial picture, that household will not be able to achieve economic security. Credit card debt is one of the most common sources of unsecured debt that individuals and families must manage.

The Tips and Tools is organized into four sections:

- ▶ Understanding Credit Card Debt
- ▶ How Credit Card Debt Affects IDA Project Participants
- ▶ Managing Credit Card Debt
- ▶ Resources for Additional Information

Understanding Credit Card Debt

What is debt? Debt is the state of owing money to an individual or to a business. There are two kinds of debt: **secured debt** and **unsecured debt**.

- ▶ **Secured debt** occurs when a person takes out a loan to invest in a specific asset like a home, a car, or a business. The loan is then secured by the asset, which means that if the person borrowing the money is unable to repay it according to the loan terms, the lender can take ownership of the asset. For example, if a person borrows money to purchase a car but is unable to make the required loan payments, the lender has the right to take the car and sell it to get back the value of the loan. This gives assurance to the lender and lessens the lender's risk.
- ▶ **Unsecured debt** is the result of using credit for something other than a specific asset. Having unsecured debt means the borrower has no asset to sell or give back to the lender if the borrower becomes unable to make the required loan payments. There is a risk to the lender with unsecured debt. If an individual does not make payments according to the agreement, there is no asset that the lender can claim to satisfy the debt. There is a risk to the borrower, too. If there is an interruption in income, the borrower has nothing he or she can sell to raise the money to settle the debt. As long as unsecured debt is part of a household's financial picture, that household will not be able to achieve economic security.

Credit card debt is one of the most common sources of unsecured debt that individuals and families must manage. In addition to the risks associated with making payments for unsecured debt like credit cards, there are other features built into credit cards that make them especially difficult for individuals and families to manage:

- ▶ Credit cards are easy to get and heavily promoted, often with low rates that last only a few months. Some people get "hooked" on using credit cards and find themselves trapped with credit card debt.
- ▶ Credit cards are revolving credit. This means that once an individual is approved for a credit card, she can borrow money up to the limit over and over again as

Research shows that IDA project participants with credit card debt are more likely to drop out of their IDA project because they have less cash available to save.

long as she is making regular, minimum payments on the credit card debt.

- ▶ Credit card companies only require a minimum monthly payment (often 2 percent of the outstanding balance). While this feature may be positive for some because it gives them access to credit, it is often one of the causes of people spending more than they can afford to pay and being unable to manage their credit card debt. In addition, when credit card users are not required to pay off the entire balance each month, they typically spend more on interest payments.
- ▶ Because of the minimum monthly payment feature, the amount an individual owes each month varies, making it hard to budget for repayment.
- ▶ Credit card companies use different methods for computing the interest, finance charges, and fees on the amount or principal borrowed. This makes it very difficult for the average credit card user to figure out how the company calculates the monthly statement and whether the charges are correct.
- ▶ Credit card companies can change the rate the credit card user originally agreed to if the user is late with any debt payment through the universal default clause. This means that the amount a person thinks they are paying for an item on a credit card could change (increase) in the future.

Credit and Debt Terms

*A **creditor** is someone a person owes money to. A creditor can be a friend, a department store, a mortgage company, or a credit card company.*

***Principal** is the amount of money a person borrows by charging a purchase to his or her credit card or borrowing in other ways. If you buy dinner at a restaurant on a credit card for \$55, you have \$55 of principal you owe to the credit card company.*

***Interest** is the amount a credit card company charges the card user for borrowing the principal, which is based on an interest percentage rate.*

How Credit Card Debt Affects IDA Project Participants

Having debt from credit cards and loans makes it difficult to save money, complete the IDA savings plan, and make the asset purchase.³ Research shows that IDA project participants with more credit card debt are more likely to drop out of their IDA project.⁴ Debt increases the chance of IDA project participants dropping out because they must repay their debt while they are saving in their IDA.⁵ As a result, these participants have less cash available to save in their IDA. When they experience unexpected challenges with their savings, they are

No Credit History vs. Poor Credit History

When someone is said to have “no credit history,” this means that the credit bureaus have no record of the individual using credit or paying bills. Having no credit history also means they have no liens or judgments outstanding or bankruptcies within the last ten years. While this may seem to be a good thing, it can impact their chance of getting a loan or a prime-priced loan because lenders have no information about which to judge the likelihood of whether they will repay a loan in the future.

While often talked about together, having no credit history is different from having “poor credit history.” Having a poor credit history means that the individual has a history of using credit, though not successfully. For example, they might have a history of having debt and/or having judgments, liens, or bankruptcies. Like having no credit history, having a poor credit history can cause an individual to not qualify for a loan or only qualify for a high-priced or subprime loan.

Building and improving the credit history as documented in a credit report is necessary for helping people with no or poor credit get better loans.

For individuals with no credit history, the general advice consists of:

- **Building credit through a secured credit card.** This only works if the individual uses the credit card and then pays it on time every month. Individual capacity to handle a credit card must be examined before recommending this course of action.
- **Building credit through a secured loan from a bank or credit union.** While this will not have the same positive impact as successfully handling a credit card, a secured loan will help establish a credit history.
- **Building an alternative credit history.** This consists of documenting regular, on-time payments to businesses that do not report positive payment behaviors to Credit Reporting Agencies. Common examples include property owners (landlords) and utility companies.

For individuals with poor credit histories, improving their credit history consists of (at a minimum):

- **Reviewing their credit histories to ensure the information is accurate.** Many people have had their credit histories negatively impacted due to errors on the part of the Credit Reporting Agencies or creditors. If erroneous information is identified, individuals should write dispute letters to the Credit Reporting Agency and creditor with any evidence to support their claims (evidence of payment, for example). Each Credit Reporting Agency provides specific guidance on preparing and remitting dispute letters on its respective website.
- **Ensuring that items that have expired are expunged from their credit reports.** Even though most items should only stay on for seven years, Credit Reporting Agencies don’t necessarily remove them.
- **Paying all bills on time every month.** This will have the biggest impact on improving both the credit history and credit score.
- **Paying down debt balances.** If the participant is unable to pay the full amount due on items that are past due, he/she can contact the creditor or collection agency to make payment arrangements.

IDA project participants must continue to repay existing debt while saving in their IDA because debt repayment is an obligation, whereas saving is optional.



more likely to drop out.

Not only is debt reduction critical to help participants successfully complete the IDA project and achieve their savings goals, but also it will help them to improve their financial health overall. Specifically, participants that are able to pay off their unsecured debt will improve their credit histories as reported on their credit reports. This will be essential when they are ready to make their asset purchases. If they have **no credit or poor credit histories (see next page for more information)**, they will have trouble being eligible for a mainstream, prime loan. Instead, it is likely that they will only be eligible for subprime

loans that are more expensive in terms of higher interest rates and fees. For example, a homebuyer paying a subprime 13 percent mortgage interest rate on a loan of \$107,500 will owe \$514 a month more than the homebuyer holding a prime 7 percent mortgage. Over the life of a 30-year mortgage, the holder of the subprime loan will pay \$184,997 more than the prime-rate borrower of the same amount.⁶

Managing Credit Card Debt

AFI grantees and other organizations administering an IDA project can play a key role in helping prospective and current IDA project participants manage their debt, and thus improve their chances of succeeding with their IDA savings goals and asset purchase.

First, the AFI grantee or other IDA project should consider reviewing the credit reports of ALL prospective participants. Many AFI-funded IDA projects do a credit history review as part of the assessment and enrollment process for prospective participants who identify homeownership as their asset goal. If an IDA project is going to do credit history reviews, project staff should think about the maximum level of debt a person can have and still enroll in the project. The maximum level of debt should be set at a level such that it is feasible for the project participant to pay down his debt and meet standard lending guidelines to qualify for a mortgage by the time he completes the IDA project.

Projects that establish a maximum level of debt for IDA participation should also establish a process to help prospective participants with too much debt to work toward qualifying for the project. For instance, projects could allow these individuals who are not eligible to enroll in the broader AFI project to participate in financial education classes. Individuals will benefit from learning basic money management skills, and perhaps they will qualify for the IDA project at a later date. Additionally, projects should refer the ineligible individuals to a credit-counseling center to seek help in reducing their debt.

Regardless of whether they set a maximum debt level for participation, all IDA projects should encourage their prospective and current participants to **focus on reducing their debt before, or at least while, saving in an IDA**. To explain to participants why first reducing debt is so important, project staff can share the following three reasons:

1. Reducing debt will ultimately help them have more cash available to save in their IDA because they will pay less in interest and fees related to their debt.
2. Debt interest rates typically exceed savings interest rates, meaning that IDA project participants with debt will likely pay far more interest on their debt than they will earn interest on their savings in their IDA.
3. And, most importantly, IDA project participants must continue to repay existing debt while saving in their IDA because debt repayment is an obligation, whereas saving is optional.⁷

The following handouts and exercises are designed to help encourage IDA project participants to manage and reduce their debt. These documents can be printed out and incorporated into a training session or handed out to participants.



- ▶ **Tips for Helping IDA Project Participants Reduce their Debt.** This document is designed for project staff. It provides information for IDA project participants on how to manage and reduce debt that staff can use during one-on-one case management sessions or incorporate into a training session or workshop.
- ▶ **Exercise Helping Credit Card Users Understand and Manage their Debt.** This document provides an exercise and worksheet that project staff can use with IDA project participants who have credit card debt. The purpose of the exercise is to help IDA project participants account for all their credit card debt and identify which debts to try to pay down first

- ▶ Tips for Taking Control of Credit Card Debt. This tip sheet on how to manage and reduce debt can be shared directly with IDA project participants with credit card debt.

Resources for Additional Information

The following list of resources provides a wide range of information, online tools, and advice on avoiding and managing credit card debt:

Annualcreditreport.com

In accordance with the Fair and Accurate Credit Transactions Act (FACT Act), individuals are allowed to request a free credit report once every 12 months from each of the three nationwide consumer credit reporting companies: Equifax, Experian and TransUnion. Individuals may go to each company's website directly or go to the centralized website at www.annualcreditreport.com/cra/index.jsp.

Credit Card Payment Calculators

Credit card payment calculators are available online through a number of websites. An example is the credit card calculator provided through Springboard-credit.org, a nonprofit consumer credit counseling agency, available at www.credit.org/resources/Tools/credit_card_minimum. Credit card payment calculators allow you to see how long it will take to pay off your credit card debt, and what you can change to meet your repayment goals.

Transunion

One of the three nationwide consumer credit reporting companies. Credit reports are available through its website: www.transunion.com.

Equifax

One of the three nationwide consumer credit reporting companies. Credit reports are available through its website: www.equifax.com.

Experian

One of the three nationwide consumer credit reporting companies. Credit reports are available through its website: www.experian.com.

Federal Trade Commission (FTC)

The FTC's Bureau of Consumer Protection provides information about credit and loans, such as checking the accuracy of your credit report, choosing a reputable credit counseling agency, dealing with debt collectors, and protecting your personal financial information at www.ftc.gov/bcp/menus/consumer/credit.shtm. Many resources also are available in Spanish.

National Foundation for Credit Counseling (NFCC)

NFCC is the national trade association for consumer credit counseling agencies. NFCC provides useful information on managing consumer debt through its organization's website: www.nfcc.org and a subsidiary website: www.debtadvice.org.

- [1] <http://www.cardweb.com>
- [2] http://www.consumer-action.org/news/articles/2008_credit_card_survey/#Topic_01
- [3] http://www.cfed.org/imageManager/IDAnetwork/IDA_Fact_Sheet_2008_09_18.pdf
- [4] http://www.microfinance.com/English/Papers/IDAs_Drop_Out.pdf
- [5] http://www.microfinance.com/English/Papers/IDAs_Drop_Out.pdf
- [6] <http://www.aecf.org/upload/PublicationFiles/DA3622H5040.pdf>
- [7] http://www.microfinance.com/English/Papers/IDAs_Drop_Out.pdf

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For more information, please contact the Assets for Independence Resource Center

Telephone: 1-866-778-6037 E-mail: info@idaresources.org