

Credit: The Problem with Consumer Debt

Consumer debt is a growing problem in our society. The average American household has 13 payment cards, including credit cards, debit cards and store cards, adding up to a total 1.3 billion credit cards in the United States. On these cards, Americans carry, on average, \$5,800 in credit card debt from month to month. If they were to make only the minimum payment on that debt every month, as almost half of Americans do, it would take 30 years to pay off — and include an additional \$15,000 in interest.¹

Far too many people live beyond their means, using credit cards to make \$1.1 trillion worth of purchases in 1999.² This spending is part of the reason the average household owes 104 percent of its annual after-tax income, if you include mortgages. Debt payments absorb almost 14 percent of American household income.³

For some, digging out of this mountain of debt proves impossible. According to the American Bankruptcy Institute, in 1999 1,319,465 people filed for bankruptcy. Of these, up to 25 percent appeared current on their bills because they took out new credit cards or cash advances to pay their bills.⁴

It is not just unwise spending habits, however, that fuel the rising debt. Credit card companies now aggressively recruit customers with cold calls and unsolicited offers, including people who are not credit-worthy. The average household receives 8 credit card offers a month.⁵ Thirty years ago, it wasn't uncommon for adults to possess no credit card since credit checks were much more stringent. In the late 1970s, however, so-called "usury" laws were changed so that credit companies could target low-income people and charge interest rates of 20 percent or even more. Now among poor families, 36 percent have credit cards and 69 percent carry a balance. Fifteen percent of poor families maintain a credit card debt that equals their monthly income and eleven percent have a debt that exceeds twice their income.⁶

These problems are particularly acute at the bottom end of the economic ladder because working people's incomes have not gained purchasing power in the last 20 years. In fact, although people worked more hours in the 1990s, their incomes still lost buying power. Credit cards allow people to try to maintain a middle-class lifestyle that is slipping away from them.

Credit also can help people in short-term emergencies since there are few government safeguards for people who experience divorce, job loss or medical bills. When these problems last for a long time, however, people set themselves up for financial disaster if they continue to accumulate debt. Debt has a shame factor attached to it that causes people to suffer in silence. Anger, perhaps, is a more appropriate emotion toward a system that encourages limitless accumulation and offers only high-interest credit to people with financial emergencies.

Bankruptcy laws are helpful because they allow people to get a fresh start. Every year in Congress, however, bills sponsored by the credit industry are proposed that would make it more difficult for low-income people to file for bankruptcy.

¹ See "Debt consolidation loans can deepen financial problems," by Pat Curry. Bankrate.com. (bankrate.com/yho/news/pf/20001120a.asp), and also (www.cardweb.com).

² "Taking Charge of Debt: Helpful Tips for Those in Over Their Heads," by Arnold Diaz and Caroline Noel. Abcnews.com (abcnews.com/onair/2020/diaz000628.html)

³ "Americans treading the waters of debt," by Lucy Lazarony. Bankrate.com. (bankrate.com/yho/news/pf/20020501a.asp)

⁴ "Debt consolidation loans can deepen financial problems," by Pat Curry. Bankrate.com. (bankrate.com/yho/news/pf/20001120a.asp)

⁵ "Debt nation," by Jenny Nelson. April 18, 2001. (pbs.org/newshour/extra/features/jan-june01/credit_debt.html)

⁶ "Living in debt: a national way of life," by Camille Colatosti. The Witness. (thewitness.org/archive/9909/currentarticle.html)

Credit: OVERVIEW

Misconceptions about credit have caused problems for people at all income levels. But those who get into debt trouble with high incomes, persons with good employability and previously strong credit histories, can win back a solid financial base fairly fast. People lacking these assets have the least capacity to recover.

Probably the biggest problem is that people view credit as an extension of income when, in reality, it is nothing more than debt. By getting heavily involved in the use of credit, families are using up tomorrow's resources today.

However, credit is not something to be completely avoided. It is necessary to function effectively in today's society. Consequently, Americans of all income levels need to understand credit, establish a safe credit limit, be able to get out of debt, and build a good credit rating.

Participants will

- Understand the uses of credit
- Know how much credit they can safely use
- Learn how to build a positive credit record
- Recognize the danger signals of credit overuse
- Know credit collection procedures and related terms
- Know available actions to take when credit problems arise

Facilitator's Checklist

- Read the Background Information
- Read through ACTIVITYs and create workshop sessions
- Review ACTIVITY instructions & background
- Optional: Obtain your own credit report from a credit-reporting agency
- Copy activity sheets for participants.
 - “Would You Use Credit?”
 - “Figuring Your Credit Limit”
 - “Establishing a Credit Record”
 - “Request for a Copy of Your Credit Report”
 - “Sample Credit Application”
 - “Using Credit Wisely”

Understanding the Uses of Credit

What Is Credit?

Sooner or later, almost everyone needs to use credit. Credit is using goods and services *now* and paying for them *later*.

There are four different types of credit:

Sales credit or installment credit is used to buy goods. This form of credit is offered by car dealers, department stores, and some mail-order catalogs.

Loans offer cash, which is usually available through a bank or finance company. Loans are used to meet unexpected expenses, make major purchases, or pay off other debts.

Credit cards, usually offered through banks, are used to purchase goods or services and can also be used to get cash. Credit cards are also offered through other sources, such as businesses and other types of financial institutions.

Service credit is used when we visit the doctor and are billed later, or for the use of household utilities such as telephone or electric service.

Buying on credit can give us the use of goods and services. However, it is important to remember that credit is not free. Buying “on time” involves charges and interest on deferred payments. These costs can add up quickly.

Credit can be an asset when used wisely. It can improve a family’s level of living. The main reason most people use credit is that they do not have the available cash to pay the total cost of an item or service at one time. Another reason is that it may be easier to pay for an item through regular installment payments rather than by saving for it.

One way to think about credit is that it helps smooth out your financial life. Imagine you are riding a bicycle and you see many hills in front of you. There are places where you will get to roll easily downhill, but other places where you will have to climb uphill. Credit is like a bulldozer that flattens out the hills. It means you don’t have to buy less when you temporarily have less money, as long as you don’t buy much more when you temporarily have more money.

Some credit is for things you consume but don’t bring any extra money, like furniture or a car, so you have to be able to pay for them with the money you expect to earn. Another way to think about credit, especially big loans like those for a home, education or a business, is that taking on the debt *now* will help you earn much more money later. These sorts of uses of credit are more like an *investment*. It makes sense to spend so much more than you are earning, only because you expect that spending that money will allow you to earn more later.

Advantages and Disadvantages of Credit

Advantages

Credit is convenient. You do not carry a lot of money with you. You can buy things that are needed when you don't have enough money on hand to pay for them. You can use an article or service before you're done paying for it.

You might be able to save money because you can take advantage of special bargains or sales when you don't have enough money with you. You may get better service if you are a regular customer and the seller holds an open account with you.

Credit can help if you need money for emergencies such as unemployment, illness, death, or property loss. A good credit history is important for future credit needs, such as buying a house or an automobile--it may mean that you can get a loan or that you can get a loan at better rates (pay less in interest and fees). Credit is convenient for making purchases through different retail options, such as mail or telephone order.

Disadvantages

Credit usually costs more than paying cash. Interest and other charges are added to the purchase price of goods or services. You may buy more than you can pay for and may even buy things you don't want or need.

Credit ties up future income. When you use credit, you owe money that must be paid back from future income. By committing to monthly credit payments, you may have to give up other things that you need.

Determining Credit Limit: How much credit can you safely use?

Families need to know how much credit they can afford to use. A common guideline is to limit credit use, excluding mortgage or rental payments, to 15 percent of take-home pay. While this may serve as a rough guideline for some people, it may not apply to others. Spending habits and economic situations influence how much credit a family can afford. A more specific guideline for safe credit use is based on the use of extra income for credit payments. That is the money not needed for basic living expenses such as housing, food, and transportation. This guideline suggests that you spend no more than one-third of your monthly extra income on credit payments. The "Figuring Your Credit Limit" handout can be used to evaluate a family's current situation and how much money can be allowed for credit payments.

How to Build a Positive Credit History

It is wise to establish a history of reliable credit payment so that credit can be obtained from a reputable source when it is needed. Families who cannot qualify for credit or have a poor credit record are sometimes forced to go to loan sharks or pay very high interest charges. Success in obtaining credit often depends on past successes. Applicants must show a good payment record before credit is granted. The reason for this is that creditors are taking a risk by making the loan, and they want to make sure that risk is not very big. Paying all bills on time is the best way to establish a good credit record.

People who have not had credit before should consider applying at a local bank or retail store. They should not apply for too many accounts at one time. Credit bureaus keep a record of each creditor who inquires about a person's credit record. Some creditors will deny an application if they think the applicant is opening too many new accounts in a short period of time.

People who have had credit before should make sure the local credit bureau has complete and accurate information about them. The bureaus can be located by looking in the Yellow Pages of the phone book under headings such as "Credit" or "Credit-Reporting Agencies." Credit bureaus keep files with information on how many and what kinds of credit accounts people have, how they pay their bills, and if they've ever filed for bankruptcy or been sued.

For married couples, loans and other accounts may be in one name only, or they may be joint accounts. A joint account should be reported on both account holders' credit histories. If one spouse does not have a credit history, he or she can establish credit by using the spouse's credit record. Simply request that the credit bureau report information in both names.

Creditors consider you to be more stable if you have lived in one location for a period of time. Therefore, people who plan to move may want to establish credit at the current location before they move. If you move to a new town, it is worth checking to be sure the credit record from the former location has been transferred to the credit bureau in the new location.

Applying for Credit

Creditors evaluate applicants for credit on their ability to repay debts. Creditors want to be sure that the applicant can repay the debt. Their evaluation of creditworthiness is based on income, stability, and credit history. Income is salary and other sources of income such as child support, social security, and welfare benefits. There may be other questions about assets such as savings, real estate, automobile ownership, or other investments.

Stability is measured by how long a person has lived at the present address and worked for the present employer. Living expenses and other credit obligations are also considered to determine the applicant's ability to repay. Credit applications usually require a signed

statement that allows the creditor to investigate the credit history and employment of the applicant.

To better prepare for teaching this material, order your own credit history. Study it to become familiar with the kinds of information included in a credit report.

Creditor Guidelines

Under the law, there are certain things that a creditor may and may not ask. A creditor *may not*:

- Ask about childbearing intentions.
- Ask about race, creed, color, national origin, or sex, except when it is required to do so by a government agency.
- Discourage applicants from applying for credit because of sex or marital status.
- Discourage participants from applying for their own individual accounts.

A creditor *may* request information about a spouse if

- A couple is jointly applying for credit or the spouse will be an authorized buyer on the account;
- The applicant is relying on community property or a spouse's income for creditworthiness.

All creditors are required by the Truth-in-Lending Act to state the cost of their credit to consumers. It is wise to shop around for the best terms by comparing the annual percentage rates (APRs). Applicants should find out exactly how much the credit is going to cost and be certain that they understand the contract before signing it. A signed contract is a legal document.

Denied Application

A credit application can be denied for several reasons. Every creditor has different standards for evaluating the creditworthiness of an applicant. One creditor might accept your application for credit, while another might not. If credit is denied, the creditor must give a written notice explaining the specific reasons why the application was denied or let the applicant know that the information is available upon request.

If credit is denied based on a credit report, the Fair Credit Reporting Act gives the applicant the right to get a summary of the credit history from the credit reporting agency. If credit is denied due to incorrect information provided by the credit bureau, the applicant can request the incorrect information be removed from the file. All creditors who received the incorrect information in the past 6 months must be notified by the credit bureau that the file has been corrected.

The Credit Bureau

Credit bureaus collect information on all persons who have used any form of credit. This credit could be service credit, such as doctor's bills or payment for housing rental. Reports can include information on mortgages, credit cards, or revolving credit accounts. Also, legal actions such as bankruptcy, tax liens, or foreclosures are recorded. This information can be provided to any business or creditor who subscribes to have access to this information.

Records of negative information remain on the credit report for 7 years. A bankruptcy must remain on the report for 10 years. Periodically, everyone should check his or her credit report. This can be done free or for a small charge, depending on the particular credit bureau. Persons who have been turned down for credit due to negative reports from a credit bureau can receive their credit reports for free from the reporting agency if requested within 60 days after denial.

Special Situations

Certain issues dealing with credit can occur, based on special situations for participants or a change in marital status.

Women

When a married woman, or a woman whose marital status has changed, applies for credit in her own name for the first time, she may be refused because she has no credit history on file. Credit records may be listed under only her husband's name. However, under the Fair Credit Reporting Act, creditors must report payment records in both spouses' names to the credit bureaus. A married woman should check the credit bureau to make certain that her name is on file. If not, she can request that her name be added, based on her husband's record.

Separation or divorce

In a divorce or a legal separation, there is usually an agreement regarding who will pay which outstanding debt. If no legal action is taken, agreements can be made between individuals. Keep in mind, however, that in either case both partners are still liable for jointly held credit debt. Creditors are not bound by divorce, separation, or personal agreements. Creditors can attempt to collect the debt from either spouse.

If any purchases are made on joint accounts, both persons may be liable for the credit purchases even after separation or divorce. Therefore, if there is a separation or divorce, the two people should close out all joint accounts, then obtain credit accounts issued in individual names.

By contrast, creditors cannot withdraw existing credit simply because marital status changes. If a person applies for new credit, the creditor checks for creditworthiness based on their regular criteria. If the individual applying for credit includes alimony or

child-support payment as a source of income, the creditors may ask for information about the individual providing the support.

Widowhood

Creditors cannot withdraw credit or refuse to grant new credit simply because one's spouse dies. A potential creditor cannot even ask if an applicant is widowed.

Applications for new credit, however, might require the individual to verify his or her own creditworthiness.

Danger Signals of Credit Problems

Almost everyone uses some form of credit. Credit allows us to obtain goods and services by paying for them with income we expect to receive. We can use the goods and services right away without waiting until we save enough money to buy them. However, credit can cause financial problems and hardship if not managed wisely.

Some families have difficulty using credit. Credit is often used as a convenient means to buy an item when it's wanted or needed. If this becomes a habit, a family can become financially overextended.

Most families can learn to use credit wisely if they know the credit danger signals and are willing to do what is necessary to reduce debt. Following are some danger signals that indicate a family may be having financial problems:

1. You pay only the minimum amount due each month on your credit cards, and outstanding balances shrink very slowly.
2. You make so many credit purchases that your total debt rarely shrinks at all.
3. You take out new loans to pay off other loans.
4. You skip payments, thus adding to interest charges.
5. You rely heavily on the automatic loan-overdraft protection of your checking account.
6. You buy items on credit that you once bought with cash.
7. You often receive past-due notices in the mail.
8. You must rely on extra income, such as overtime wages, to make ends meet.
9. You cash in bonds before they mature or use savings to pay current bills.
10. You face an ever-widening gap between income and expenditures.
11. Your credit for things other than a mortgage is at least 20 percent of your take-home pay, or the payments are more than available discretionary income.
12. Bills are turned over to a collection agency.
13. You post-date checks.
14. You are turned down for credit because you have a poor credit report or too many outstanding debts.

What Happens If Bills Aren't Paid: *Options for Creditors and Choices for Debtors*

What happens when bills are not paid depends on the credit contract. People who fall behind in their payments often face ever-increasing pressure to pay. One of the first actions taken to make debtors pay their bills is a letter asking for payment. After that, there may be a telephone call. If this does not get results, a creditor may follow up with several options.

Collection agency

If bills still are not paid, the debt is probably turned over to an independent collection agency. The agency will try to get payment on the debt. Collection agencies, however, are prevented by law from doing certain things to debtors. Debtors have the right to tell the agency in writing not to contact them. Also, the collector

- May contact debtors only between 8 a.m. and 9 p.m.
- Cannot discuss someone's financial situation with others, but can ask others how to find a debtor.
- Cannot use abusive language or threaten violence.

These guidelines apply only to collection agencies. The actual creditor is not held to these guidelines.

Wage assignment

By signing a wage assignment, consumers give their creditor the right to their future wages. If a payment is missed, the creditor simply tells the debtor's employer to withhold part of his or her wages. The creditor does not need a court order to do this. Although employers are not legally bound to honor the creditor's request, they usually do. The law offers no protection against being fired for a wage assignment.

A recent Federal Trade Commission rule has taken much of the sting out of wage assignments. It may now be included only in a purchase contract with a clause allowing the consumer to cancel the wage assignment at any time.

Acceleration

This clause is written into some purchase contracts. A creditor has the right to claim the entire amount due if a payment is missed. The courts can force debtors to pay by seizing property and selling it.

Repossession

The creditor can seize the item bought or the property put up as collateral.

The creditor can repossess without notice. If the sale of the property brings less than the amount owed, the debtor must pay the difference.

Wage garnishment

Creditors must get a court order to garnish wages. Employers then withhold part of the debtor's wages and pay it to the creditor. Only one creditor can collect at a time. Others must wait, and often their collection efforts stop. The law limits the amount that can be withheld, based on family size and special circumstances. The same law protects debtors from being fired as a result of garnishment for one debt. However, there is no protection against being fired for a second garnishment.

Foreclosure

If homeowners do not make their mortgage payments, lenders may start foreclosure proceedings. Usually, on the third month, an attorney may be instructed to start foreclosure. The attorney's fees of \$500 to \$3,000 (or more) are added onto the amount owed.

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cosigner; the merchandise can be repossessed; or the creditor has the power of a wage assignment. These bills could be a car note, mortgage, bank loans, or furniture bills. If consumers are not sure which loans are secured, they can check the credit contract.

Although unsecured bills may have lower priority, consumers are obligated to pay them, too. With these bills, the creditor eventually may have to proceed with court action.

Whatever choice a family makes, family members should ask themselves how much they have already paid and how much is owed. If only one or two payments remain on a bill, it is probably a good idea to make them and get that debt out of the way. It may be possible to return newer items, or sell them and pay off the debt.

Finally, debtors can check the interest rate they are paying on each outstanding bill. Interest rates are often highest on credit cards. It is probably best to pay off loans with the highest interest rate first, to reduce the finance charges being paid.

Making it work

After a family has decided how to handle credit debts, they must try to carry out the plan. Until a family gets back on its feet, family members should be encouraged not to use credit.

Families who have trouble making payments may pretend to themselves and others that they have no money problems, but this does not make it easier. Openly discussing spending problems with family members helps everyone realize that cutting down is a must until debts are paid.

Getting Help for Financial Trouble

A family that is financially stressed (by overextended credit, change in income, or a sudden increase in expenses) may want to consider seeking the advice of a financial counselor. A not-for-profit agency such as the Consumer Credit Counseling Service (CCCS) is recommended. Call (800)388-CCCS to locate the CCCS in your area. Following are other strategies to consider.

Consolidation loan

A consolidation loan is a single loan taken out to pay off all other debts. The payments on the new loan are lower than the total of all the old payments because they stretch over a longer repayment period. It is easier to keep track of the debt because there is only one payment. But debtors may end up paying more interest, and over a longer time. There is a danger of forgetting how much is still owed because the new payment seems so small compared to the previous total. *A consolidation loan can work only if debtors give up using any more credit and work to balance spending and income.*

Bankruptcy: Chapter 13 (The wage-earner plan)

If debts cannot be settled, Chapter 13 of the U.S. Bankruptcy Act (the Wage Earner Plan) may be the answer. The debtor probably needs the help of a lawyer to file the plan. The attorney and client work out a repayment plan that must be acceptable to the Chapter 13 trustee who represents the creditors. Generally, the court agrees if the family's total, necessary living expenses are not more than three-fourths of take-home pay. The remaining amount would then go to repay debts within 3 years. Creditors usually accept such a plan because they are more likely to get some money than if the customer files for straight bankruptcy. Some plans pay back the whole debt, but most propose to pay less. Every payday, a fixed amount is paid to a court-appointed trustee, who pays the creditors. Lawyer's fees, court costs, and trustee's fees may be paid in installments along with the other debts.

Bankruptcy: Chapter 7 (Straight bankruptcy)

Filing for bankruptcy, Chapter 7, should be a last resort. It is not an easy way out, and it lets down people who trusted that their customers would pay their debts. Once debtors file for bankruptcy, they may not do so again for 7 years. Bankruptcy appears on credit reports for 10 years, making it very difficult to get credit during that time. Fees and court costs must be paid in advance.

Once people declare bankruptcy, their possessions (except those exempted by state law) are turned over to the court trustee to be sold. The money is then paid to creditors in proportion to the amount owed them. Anything remaining unpaid is a loss to the creditor, and the debts are discharged. Debts that cannot be discharged through bankruptcy include child support, student loans, and taxes.