Capitalizing on New Consumer Protections

CRL Research Brief

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Four Tips to Rid Yourself of Credit Card Debt Sooner and Save Money

The Credit CARD Act of 2009 made sweeping consumer-friendly changes. The law's key protections took effect on February 22, 2010. This brief provides some tips on how to make the most of the new law, but it is not a comprehensive guide to the reforms.[1] In a nutshell, CRL advises consumers to take four steps:

1) **Pay above the minimum amount due! Paying more than the minimum can save you as much as $2 for every extra $1 you pay**. For example, before the CARD Act, paying $100 extra could save you $164 in interest charges, but now that same payment amount can save you $224.

2) **Continue to watch out for hair-trigger penalty rates. Issuers can still raise your interest rates on new balances for the slightest reason.** It is particularly important to pay above the minimum if you get hit with a penalty rate. Doubling your payment could cut your interest charges over the following four years by more than half.

3) **Don't opt in to over-the-limit coverage.** Over-the-limit coverage is a bad deal because it means that if you go above your limit, the credit card company will extend you additional credit at an exorbitant cost automatically – as much as 4,215% APR (annual percentage rate) – instead of rejecting your card. A better option would be to call your issuer to see if you can have your limit raised, or apply for additional credit elsewhere.

4) **Avoid arbitration clauses in credit card contracts.** Protect your rights. There are now more card options without arbitration clauses and you should ask your credit card company for such a card. Forced arbitration requires the borrower to resolve any dispute with an arbitrator and not in court. Research shows decisions in arbitration favor card issuers, rarely the wronged borrower.

About the Center for Responsible Lending

The Center for Responsible Lending (CRL) is a national nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

For additional information, please visit our website at **www.responsiblelending.org**.

[1] There are several summaries of the Act available online. One good guide to the Credit CARD Act of 2009 is available at: http://www.creditcards.com/credit-card-news/credit-card-law-interactive-1282.php

Pay More, Save More and Improve Your Credit to Boot

For cardholders who maintain a credit card balance, paying more than the minimum has long been a smart strategy. By reforming obscure and complex methods credit card companies used to apply payments, the CARD Act has made this strategy pay even greater dividends.

Multiple Balances on Credit Cards
This brief describes several scenarios that show how paying above the minimum is in your best interest. Many people do not realize that their credit card can have several balances at different APRs (a cash advance, a promotional or "teaser" rate for initial purchases, and a purchase rate). All the scenarios discussed below involve corresponding multiple interest rates for each balance, since that is when the practice of payment allocation really matters.[2] Under the CARD Act, having multiple balances at different rates can occur for a new reason. Issuers are limited in the rate changes that they can make on existing balances, but they can still change rates on new balances freely, as long as they give notice. This can create multiple balances at different interest rates.

In December 2008, CRL issued "What's Draining Your Wallet," a report detailing how credit card issuers adopted methods that allocated payments in ways that disadvantaged customers. These methods led to higher charges and longer repayment periods.[3] Under the new law, issuers must apply payments in a way that is much more favorable to the customer, but there is a catch: **The change only affects amounts paid over the minimum**. Before February 22, 2010, when you made a payment towards your credit card debt, the whole payment went to the **lowest** interest rate balance, leaving higher-cost balances unpaid. Since February 22, any payment <u>over</u> the minimum must go to the **highest** interest rate balance (saving you from future interest charges).

Since, however, the minimum payment amounts may still be applied to the lowest-interest rate balance, you must change your payment behavior to benefit from this change. If you make only the minimum payment you will gain nothing from this reform. **The larger your payment, the greater your benefit in savings.**

Figure 1 shows the impact of making a one-time $100 extra payment in two scenarios:[4]

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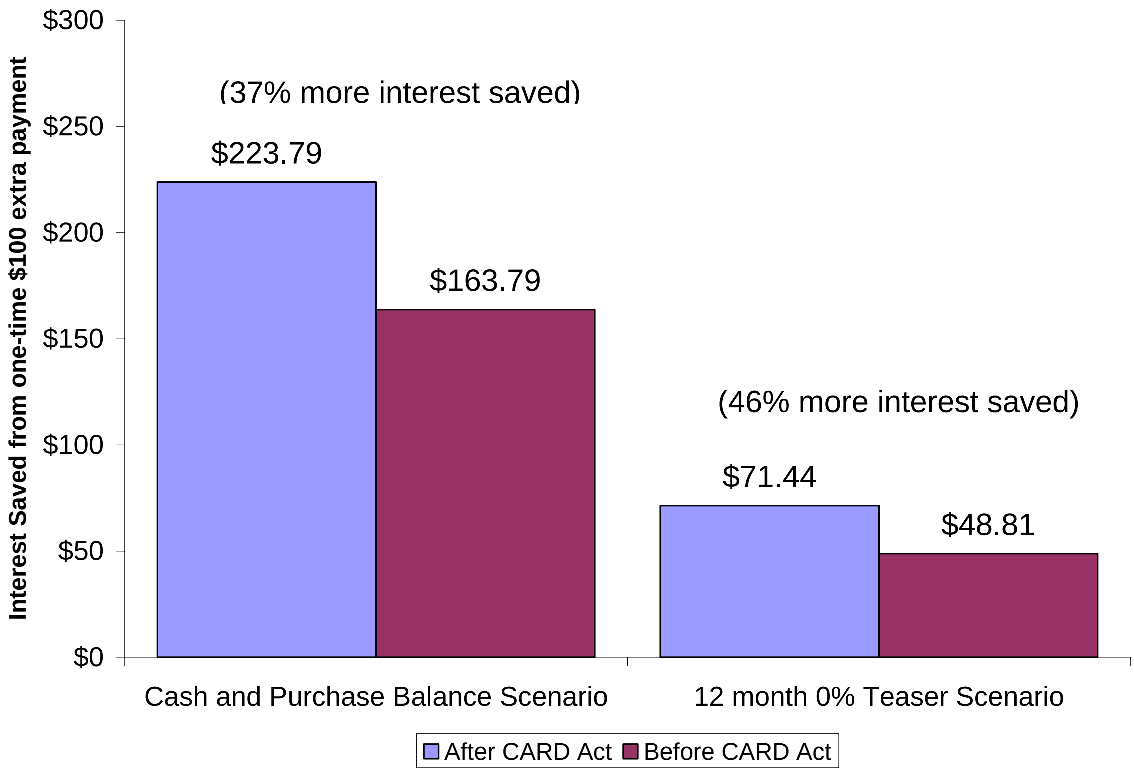
[2] As discussed later, multiple interest rates on a single account may become even more common than ever under the new rules.
[3] "What's Draining Your Wallet? The Real Cost of Credit Card Cash Advances." Center for Responsible Lending, December 16, 2008b. Available at: http://www.responsiblelending.org/credit-cards/research-analysis/what-s-draining-your-wallet-the-real-cost-of-credit-card-cash-advances.html.
[4] The scenarios are based on a $10,000 initial balance divided equally between the two APR categories. The regular APR was assumed to be 14.6% based on the average rate in the March 10, 2010 survey from creditcards.com. The promotional APR was assumed to be 0% for 12 months. The cash APR was assumed to be 9.7 percentage points higher than the regular purchase APR based on CRL estimates of the average difference in new solicitation data from Mintel Comperemedia. The minimum is assumed to be 3% (2% is more common but may cause negative

In Scenario 1, a consumer carries a credit card balance for both purchases and cash advances. (Cash advances charged against your card are assessed at a higher APR than purchases or balance transfers.) In this scenario, paying above the minimum even once can result in a large savings: for example, paying $100 more in month one saves $224 in interest expenses. **This implies every dollar paid above the minimum can result in more than $2 saved in interest costs over the life of the loan (in addition to the reduction in principal).**[5]

In Scenario 2 (a credit card with a 0% teaser rate for 12 months), the savings are smaller but still substantial, with a $100 extra payment reducing total interest paid over the life of the loan by $71 in addition to reducing the principal by $100.

Most important, in both scenarios, paying more than the minimum gives you far more bang for your buck now than before the new law. The $100 payment results in savings in interest costs between 37% and 46% lower than they were before the Credit CARD Act.

Figure 1: Impact of making a one-time $100 extra payment before and after the CARD Act



amortization with the higher cash advance APR and for consistency all minimum payments were kept the same). Minimum payments were assumed to be no less than $20, which is the most common cut-off used by issuers.

[5] The amount saved depends on the exact circumstances. Extra payments at the beginning of the repayment period generally have more impact.

As an added benefit, paying above the minimum also can help to increase your credit score. The amount of debt relative to credit limit is a factor that comprises about 30% of credit scores. Higher payments result in lower balances and make this factor look better to creditors. As credit scores increase, you may find that you pay less for other credit.

Hair-trigger Penalty Rates and Universal Default Still Exist, but Paying More Can Help

Issuers in general can no longer change the interest rate on a cardholder's existing balances.[6] However, issuers can raise rates without limitation on new balances incurred after the CARD Act's implementation (they now have to give you 45-days notice). These increases in the rate for new balances can still take the form of a hair-trigger penalty rate incurred because a payment on a current balance was just one day late. The practice of "universal default" on new balances is also still legal, in which a borrower is hit with a penalty rate on new balances for being delinquent on a completely different loan or even just for a decline in credit score.

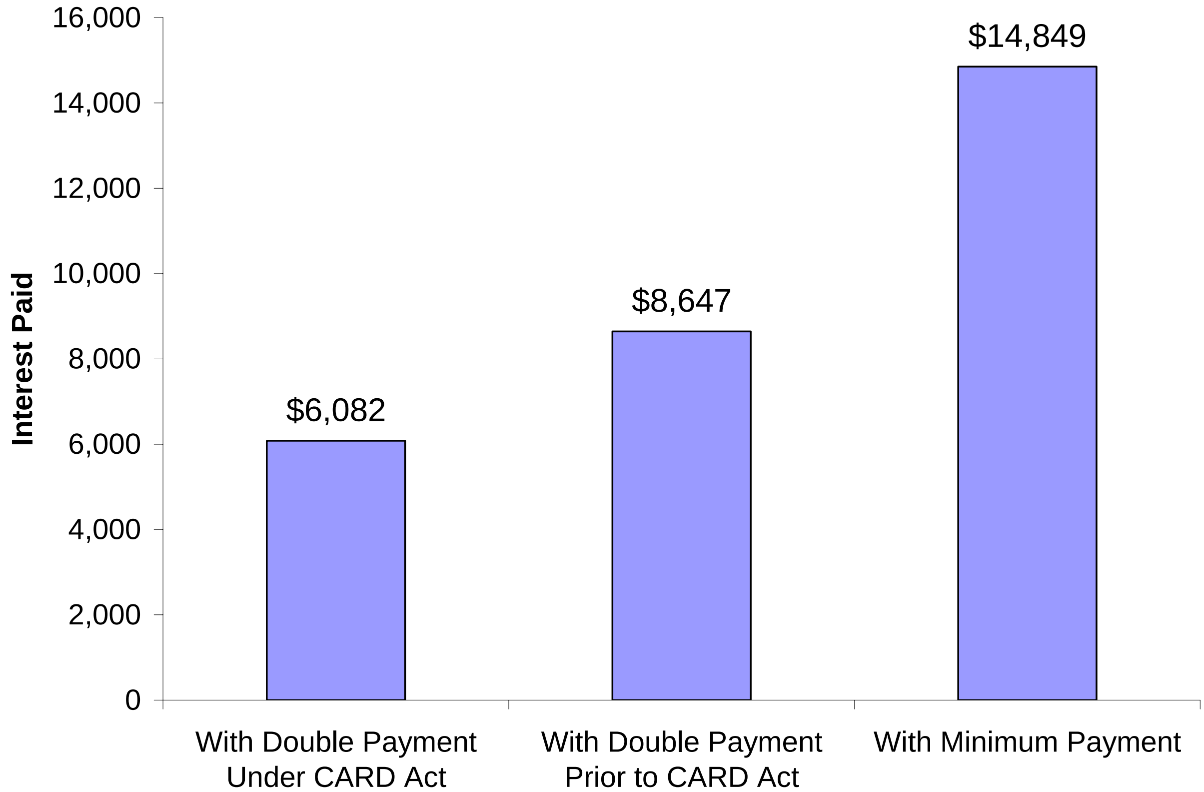
Figure 2 shows the impact of the new payment allocation method on someone facing a penalty rate on new balances who continues to make purchases. In both cases, the individual is assumed to pay double the minimum payment.[7] Eventually, as he continues to make purchases, the entire balance shifts to the new penalty rate under both the new and the old rules. However, the higher rate jump happens more quickly – a year and a half – using the pre-Credit CARD Act rules.

The more favorable interest rate in the first four years results in about $2,500 less in interest charges. If he did not double his payments at all, a borrower just making the minimum payment would pay interest costs of $14,849 (compared to $6,082 with double payments under the new rules). A sum total of $8,767 extra goes to the credit card company because his minimum payments weren't doubled up.

Figure 2: Interest paid over four years when there is a penalty rate on new balances

[6] The main exceptions are changing a variable rate in line with an index, ending a pre-stated teaser rate, or imposing a penalty rate when an account is 60 days past due.

[7] The scenarios are based on a $10,000 initial balance starting entirely in the non-penalty APR category. The regular APR was assumed to be 14.6% based on the average rate in the March 10, 2010 survey from creditcards.com. The penalty APR was assumed 16.9 percentage points higher than the regular APR based on results of the 2008 CRL study, Joshua M. Frank, "Priceless or Just Expensive? The Use of Penalty Rates in the Credit Card Industry," Center for Responsible Lending, December 16, 2008, available at: http://www.responsiblelending.org/credit-cards/research-analysis/priceless-or-just-expensive-the-use-of-penalty-rates-in-the-credit-card-industry.html. The minimum is assumed to be 4% (this was raised because the 3% rate would cause negative amortization at the penalty APR). Minimum payments were assumed to be no less than $20, which is the most common cut-off used by issuers. The consumer is assumed to make $400 per month in monthly purchases at the new penalty rate. The elevated payment amount was 8%. Only 4 years are shown because the life of the loan is infinite due to the ongoing purchases. At the end of 4 years, the loan balance is between $7,000 and $7,500 dollars, depending on the rules used.



You can avoid the balance shifting to the penalty rate over time entirely by making a high enough payment (in this case, higher than the double payment used here). **A good rule of thumb for borrowers who revolve their balance and have a penalty rate on new balances is to pay the minimum payment PLUS a little bit more than the amount of new purchases and cash advances they make**.[8] Cardholders who keep their payments this high will be able to maintain the low rate they had before the rate increase on almost all of their balances long-term.

Opt-in for Over-the-limit Fees: Borrower Be Wary

The Credit CARD Act prevents issuers from charging an over-limit fee unless cardholders opt-in to this program. Some issuers have responded to the law by eliminating these fees altogether, while others have chosen to call their customers to encourage them to opt-in. Some credit card companies claim that consumers should opt-in so that they can exceed their credit limit for a number of transactions rather than having their card rejected. In fact, when you opt-in, you are allowing the credit card company to automatically charge you exorbitant interest every time you inadvertently spend over your card limit.

[8] The payment needs to be “a little bit more” than the purchases and cash advances to counter any finance charges on those new balances. These finance charges might typically be between 2%-3% of the new balance, so a payment of the minimum payment +103% x (new purchases and cash advances) would generally be sufficient.

The opt-in option offered typically is an extension of additional credit with costs similar to an overdraft loan on a checking account or payday loan. It is among the most expensive consumer loans available, with effective interest rates (APRs) in the hundreds or even thousands of percent.

Table 1 shows the APR paid by consumers who opt-in to over-the-limit fees compared to other credit card interest rates.[9] There are two columns for over-limit fees because the Federal Reserve has proposed rules that put some limits on their size.[10] The proposed rules still allow lenders to charge an excessive price for credit (1,215% APR), although this is lower than the 4,215% APR allowed by previous law. The table assumes amounts are borrowed for a full month.[11] While the new rules are not yet final, the bottom-line is clear: **absent dramatic changes in pending Federal Reserve rules, do not opt-in to over-the-limit offers.**

A better alternative to opting-in to an over-limit fee would be to call your issuer to see if you can have your limit raised. If they are unwilling to do this, apply for additional credit elsewhere. The best option, if possible, is to keep your credit card balances as low as possible so that exceeding your limit is unlikely to become an issue.

Table 1: APR Using Credit Card Loan Products

Amount Borrowed for one month	Standard Credit Card Purchase APR	Credit Card Cash Advance	Over-Limit Transaction (current rules)	Over-Limit Transaction (Fed Proposed Rules)
$10	15%	602%	4,215%	1,215%
$20	15%	302%	2,115%	1,215%
$50	15%	122%	855%	855%
$100	15%	62%	435%	435%

Forced Arbitration Clause in Your Card Contract = Goodbye to Legal Recourse

Arbitration— one of those clauses tucked away in the fine print of your credit card agreement— is especially troubling because it bars borrowers with clearly valid claims from taking action through a court of law. Instead, consumers are forced to file a complaint with a private arbitrator

[9] Cash Advance assumes a minimum cash advance fee of $5. About half of large bank issuers have fees higher than this. Over-the-limit fee is assumed to be $35, the most common amount currently used. The proposed Federal Reserve rules would make these fees more "reasonable and proportional" in August 2010 by requiring that they be no more than the amount one is over the limit (i.e. the amount borrowed here). Since over-limit transactions typically last for less than the one month shown, the actual APR in most cases would be considerably higher.

[10] These proposed rules on penalty fees are required by the Credit CARD Act, however unlike most other provisions, they will not be implemented until August 2010 and the strength of these rules depends on the interpretation of this portion of the Credit CARD Act by the Federal Reserve. As of the publication date, these rules have not been finalized and may be stronger or weaker in their final form.

[11] In many cases the over-limit time period will be less than a month, implying an even higher APR.

whose decision is usually not subject to meaningful review in court, and the arbitrator has an incentive to side with the lender.

CRL research has shown that private arbitration forums tend to have biased results in favor of the credit card companies.[12] Due to conflicts of interest and other issues exposed by the Minnesota Attorney General, Lori Swanson, in 2009, the nation's largest consumer arbitration forum has stopped its consumer arbitration work as part of a settlement.[13] This settlement prompted some large issuers to eliminate arbitration clauses in their contracts, freeing consumers to try other options.

On one hand, the Credit CARD Act's passage means cardholders now have more rights. However, if issuers do not follow the rules and recognize these rights, the borrowers may have difficulty enforcing those rights alone if they are required to go to private arbitration. The upshot for cardholders is there are more options now to find a card without an arbitration agreement. That new card would enable them to go to court if their credit card company violates the law.

The New Law Marked Progress, but You Must Act to Take Full Advantage

The Credit CARD Act has put an end to some of the worst credit card issuer practices. However, to fully realize the benefits of the law, follow the tips presented in this brief.

The new law, although good progress is no excuse to let down your guard: pricing tricks continue, and some new ones have started. Avoid focusing on gimmicks such as a short-term teaser rates, and focus on the overall price, including potential fee costs in addition to the APR.

There are additional tips and important information on credit cards at www.responsiblelending.org.

[12] Joshua M. Frank, "Stacked Deck: A Statistical Analysis of Forced Arbitration," Center for Responsible Lending, May 2009, available at: http://www.responsiblelending.org/credit-cards/research-analysis/stacked-deck-a-statistical-analysis-of-forced-arbitration.html
[13] Maria Aspan, "Next Consumer Backlash: Arbitration," American Banker, July 21, 2009.