

Credit Cards

A Mind of Men Extended Show Note

<http://www.mindofmen.com>

Mind of Men Episode 110

November 9, 2009

And welcome back. You may recall that back in February of 2008, we did a pair of podcasts on the topic of personal finance. We talked about a lot of general stuff then and only touched on the topic of credit cards. With the recent financial crisis, credit cards have been in the news a lot ranging from the new Federal Law that President Obama signed earlier this year - The Credit Card Accountability, Responsibility and Disclosure Act (or Credit CARD Act) to some of the very questionable things that credit card companies have been doing over the past few months such as raising fees, interest rates, and minimum payments as well as cutting credit limits.

Chances are that no matter how good your credit score is, you have felt the impact of these changes in one form or another. We figured that with the holiday shopping season about to get under way it might be a good idea to take a look at the whole credit card picture to get a better understanding of what is happening, why it's happening, and what we might be able to do about it. As with some of the other areas we have covered in the past, I'd like to begin with a disclaimer. I am neither an attorney nor a Certified Financial Planner. I do however have a business background and have played the credit card game for more than 20 years. I have been in the position of many Americans in that in my younger years I carried a five figure credit card balance for some time and was not as diligent as I now am about keeping my credit history spotless. On the other hand, today I rarely carry a balance and have an excellent credit score, so I think that I can speak from experience to the entire spectrum of the credit consumer. So, while you should not consider any of what follows as professional advice or guidance, I do hope that you can glean some useful tidbits from it.

History of Credit Cards

The concept of using a card to purchase goods and services was first described in Edward Bellamy's 1887 book, *Looking Backward*. In it, the term "Credit Card" is used 11 times. The earliest credit cards were likely cards issued by gasoline companies in the 1920's to facilitate purchases of their products. Over time, the various gas companies entered into agreements to accept each other's cards. During the 1930's and 1940's, many stores maintained credit accounts for regular customers. The Charge-Plate, which used a small sheet of metal embossed with the customer's name, city, and state that was then run through a machine which embossed the information on a charge slip was one early example and is why you sometimes hear older folks use the term charge plate when referring to charge cards. In fact prior to the advent of electronic payment networks, credit cards used a similar process in which they were laid down on an embossing machine, a sales slip with the purchase amount and other information placed over it, and an inked ribbon rolled over it to transfer the details of the customer's cards onto the charge slip.

In 1950, Diner's Club became the first general purpose charge card although it had to be paid in full at the end of each month. Diner's Club was followed by other companies including American Express who released their first card in 1958. These were charge cards not credit cards. They were only intended to be used to facilitate payment so that consumers would not have to carry cash or use checks. You had to pay the balance off in full each month. Charge card companies made their money from users through an annual membership fee and from merchants who were charged a small transaction fee for each purchase.

The same year that American Express entered the market with their charge card, Bank of America launched what would become the first successful revolving credit card, the BankAmericard which later became Visa. In 1966, a group of California banks got together to launch a competing product, called Master Charge, which later evolved into MasterCard.

Basic Types of Cards

Okay, with the history lesson out of the way, let's look at the three basic types of card in the U.S. and explain how they work.

The newest type of card is the debit card offered by your bank. Although it may bear the logo of Mastercard or Visa, do not be fooled – this is not a credit card. If you don't have the sufficient funds in your bank, your purchase will be denied and there is no grace period on the purchase – the money comes out of your account immediately.

Merchants prefer debit cards as the fees are usually the lowest of the three types of cards. For me, I rarely use them as most don't offer any rewards programs and I would rather use someone else's money for a few weeks, especially for larger purchases. Furthermore, fraud protections are generally better for credit cards than for debit cards. One example is that if you notice that your debit card has been used fraudulently, you can be liable for \$500 of loss with a debit card versus only \$50 of loss with a credit card depending on how quickly you report it.

The second type of card is the traditional revolving credit card. While there are a number of different ones on the market today, the two most common are Visa and Mastercard. One thing to note here is that Visa and Mastercard don't actually issue cards; instead, they provide the payment network which enables a merchant to get paid when you use your card in their store. The cards are actually issued by banks, which in turn set the criteria for card issuance. This is why you see such variation in the terms and reward programs offered. Revolving credit cards allow you to charge something and then pay it off over time. Usually you have a grace period from the time you make your purchase to the time the payment is due and if payment is received in full by that time, you pay no interest. Banks make their money by charging interest, fees to consumers, and transaction fees to merchants.

The third type is the Charge Card. Common examples are American Express and Diner's Club. These cards require the balance to be paid off each month in full. They make their money by charging users annual membership fees and charging merchants higher transaction fees. This is one reason by the way that merchants are less likely to accept an American Express card than a Visa as they have to pay more to run a purchase through Amex's network.

Over the last 25 years or so, the lines have been blurred a bit. American Express now offers a line of revolving credit products such as the Optima and Blue credit cards and Diner's Club formed an alliance with the Visa network to increase the number of places that accept it.

The Current Credit Card Environment

With that background out of the way, let's talk about the current credit card environment. To understand how we got to where we are today, it helps to understand some of the underlying problems. Contrary to what you may have heard or read about the financial crisis, one of the key underlying causes of it was a lack of liquidity in the short term lending market. Most large businesses rely on the availability of short term credit to fund their daily operations. Businesses generally are not cash based in that they do not receive cash payment on the spot for the goods that they sell. They usually sell things on credit to their customers with the expectation that debts will be settled within 30-60 days. As such it is not unusual to see a company have record sales, but run out of cash as they have to wait a month or so before they receive actual payment for the goods that they have sold. Due to this lag, companies often find themselves in the position where one month they are cash rich and another cash poor. To keep the system functioning, there is an active market in which companies with surplus cash lend money to companies that have cash needs. Usually, this process works very well. Unfortunately, sometimes it breaks down and when it does, those companies that are in a cash poor position can suffer.

When the crisis hit, companies stopped lending to each other. Those that had money hoarded it in case they needed it down the road and were not willing to lend it to other companies since they did not know if a company they lent money to would go out of business and take their investment with them. It was bad enough that companies were doing this, but it got worse when the banks got into the game as well. Like companies, banks lend to each other all the time and with the collapse of Bear Sterns in 2008, banks got scared and stopped lending to each other.

This in turn caused a nearly complete freeze in the credit markets and credit tightened up considerably. Credit lines became an increasingly valuable commodity and banks and others started reeling in it. Furthermore, they started to take a hard look at the interest that they were earning on their loans and tried to shift their credit lines to safer and higher paying investments. Banks make a lot of their money by borrowing funds at a low rate and then loaning it out again at a higher rate. Their income comes from the spread between what they pay in interest on money they borrow and what they make in interest on loans they make to others. When the credit market tightened and it became harder for banks to borrow money, this in turn meant a cutback in the money that they could loan out.

This situation explains a number of things that many credit card holders saw. First of all, even people with excellent credit and a long history of paying on time saw their credit limits reduced. We talked about a story some months ago in which a consultant who had an American Express card had his limit reduced month after month as he paid down his line. In that case, he was profiled based on where he lived – he had a house in a Virginia suburb that had experienced a sharp drop in home values and consequently he was placed into a high risk pool by American Express through no fault of his own.

Another thing that many cardholders noticed was that the minimum payment they were required to make each month shot up. Beginning in August of 2009, Chase raised the minimum payment from 2% of the outstanding balance to 5%. In real dollar terms, this means that if you carried a balance of say,

10,000 on your credit card, your minimum monthly payment would skyrocket from \$200 to \$500. For someone living paycheck to paycheck, this could literally be the straw that breaks the camel's back. \$10,000 by the way is actually a little less than the average credit card debt of \$10,679 per household at the end of 2008 according to CreditCards.com

One reason that is cited for this move is that like many credit card companies, Chase extended low interest balance transfer offers to many consumers. The way these work is that in exchange for your transferring a balance from another card, Chase agrees to offer a low interest rate on the transferred amount until it is paid off. This sort of arrangement is fine when there is lots of credit to go around but when the financial crisis hit and credit markets dried up, banks had less money to loan out since they themselves could not borrow money. If a bank can no longer increase its income by borrowing and loaning money, it needs to increase its return on its existing pool of loans. It can do this in one of two ways; encourage people with low interest loans to pay them off more quickly and/or to sock customers with lots of fees. Changing the minimum payment amount accomplishes both of those objectives; people either pay off more of their balances and/or they can't pay and are whacked with underpayment penalty fees and higher interest rates because they are in default.

This is essentially what is happening across the board. Consumers are seeing hikes in rates, fees, and minimum payment amounts.

Credit Card Legislation

As I noted earlier, President Obama signed the Credit CARD act into law this past year in an effort to protect consumers from some of the predatory practices that card companies are increasingly using. Unfortunately, while the law did do some good, it also missed a lot of areas – you can bet that the credit card companies lobbied hard and long to ensure that a lot of the teeth got taken out of the final bill.

Let me summarize some of the protections the law implements;

- Requires banks to mail bills at least 21 days before the due date and give 45 days' notice of changes in APR, fees, and other key terms.
- Allow you to opt out of rate hikes and fee increases and to close accounts while paying off the balances under the old interest rates.
- Restricts interest-rate increases during the first year of card use.
- Prohibits banks from charging over limit fees, unless you sign up to be allowed to exceed your credit limit.
- Prohibits rate increases on existing balances unless you're 60 days overdue.
- Gives you the right to revert to an older, lower interest rate after making on-time payments for six consecutive months.
- Requires banks to apply payments to the balances with the highest interest rate first.

At the same time, the law doesn't

- Prevent issuers from imposing annual fees on credit accounts.

- Set a ceiling on interest rates.
- Allow you to opt out of increases in the minimum monthly payment.
- Require banks to give you notice if your borrowing limit is lowered or your credit card is canceled.
- Require banks to notify you if your interest rate goes up because of an increase in prevailing rates, such the prime rate.

Furthermore, the law does not go into effect until February of 2010, so credit card companies have been working overtime to raise rates and fees ahead of the February implementation date.

There is one very important consumer protection that is coming with this new law, however. Today, if you carry a balance and are late with a payment, in most cases, the credit card company has the right to cancel any promotional interest rates and jack you up to their default rate. For some banks, the default rate approaches 30%, which could be a tremendous blow if you carry a high balance. Once the credit reform law goes into effect, while the credit card company can still do this for new purchases, any balance you are carrying must remain at the original agreed-upon rate. So, bottom line; don't miss any payments or do anything that would allow the banks to jack up the rate – at least until the law goes into effect.

So that we can understand what the changes mean, let's have a look at typical set of credit card terms. Since I've already talked about Chase, let's use them at our discussion example. The information we are about to cover comes from Chase's own website in the Pricing and Terms section for their Freedom Cash back Credit card.

The first thing is the APR. In the old days, I can remember seeing a single APR that applied to most consumers. Sure, there might be a limited time promotional APR – say 0% for the first six months or so, but once that period passed, the standard APR applied to everyone as long as they kept their account in good standing. That is no more. Chase provides three different annual percentage rates for purchases that depend on your credit history. All of them are pegged to the Prime Lending Rate which is the interest rate that banks charge their best business customers to borrow money. The Prime Rate is generally considered a low risk rate and consequently is usually much lower than any interest rate the average consumer is likely to get. Interest rates basically increase as the risk increases and since unsecured debts like credit cards are considered very risky, a fairly sizable premium above the prime rate is applied.

One other thing to keep in mind is that right now, the Prime Rate is still considered near a historical low at less than 4%. Over the next few years, it is almost certain to rise. A recently as two years ago, it was over 8%, so bear in mind that interest rates could go up quite a bit depending on what the Prime rate does.

In Chase's case, you will pay Prime rate plus either 9.99%, 14.99%, or 19.99% depending on your credit record. This translated at the time of this recording to an interest rate of 13.24%, 18.24%, or 23.24%.

Now those rates are for purchases. What if you want a cash advance? Really bad idea. First of all, most credit cards including this particular one from Chase will hit you with a cash advance fee that is 3% of the amount of the cash advance, with a minimum amount of \$10. So, if you hit the ATM with your credit card to withdraw a couple hundred dollars, you are going to pay \$10 plus whatever the ATM vendor decides to charge for the privilege. Even worse, you pay a higher interest rate on a cash advance – in Chase’s case either 19.24% or 23.24% depending on your credit record plus you don’t get any grace period. The credit card company starts charging interest the moment that money comes out of the bank machine.

Speaking of cash advances, let’s talk about those great deals that credit cards offer to try and entice you over to them. They’ll often offer something like a low interest rate for a specified period of time (usually six to twelve months) in exchange for having you transfer your credit card balance from another bank card. Don’t be fooled here – these guys are in it to make money and they have all kinds of neat little tricks with which to do it. For one, there is usually a balance transfer fee. Secondly, while purchases usually have a grace period before you begin to be charged interest on them, balance transfers often do not which means you begin to pay interest as soon as the transfer happens.

To see how this works in practice, let’s take a look at Discover’s More card. First of all, I do have to give credit where credit is due. Discover, like the Chase example we talked about earlier offers three different interest rates and terms depending on your credit. Unlike Chase, however, Discover defines what it means by Excellent Credit, Average Credit, and Needs Improvement. For the purposes of this discussion, let’s assume that you fall into the Needs Improvement category in that you have been more than 30 days past due with a payment three times in the last 2 years.

Discover’s offer is for a low credit rate; 3.99% to be exact for six months. After that, you will pay the standard rate of 18.99%. On top of that, you will pay a 5% transfer fee. So, let’s say that you currently have a card with a 5,000 balance. Upon completing the balance transfer, you will be assessed a \$250 transfer fee, plus, you will begin accumulating interest at nearly 4% a month. You have to be careful though – if you miss a payment, Discover has the right to cancel the low introductory rate and bump you to their default rate which can approach 30% today and will likely go higher as the prime interest rate starts to climb.

Fees and other dirty Tricks

Remember earlier I mentioned that fees were one way that credit card companies can boost their bottom line. Well, they have all kinds of ideas on that score ready to roll out.

Fees for Good Customers Today, unless you carry a charge card such as a traditional American Express card which requires full payment of all charges each month, banks really don’t want you to pay your bill in full each month. They make a fair amount of money collecting interest on your balance and are not pleased when they can’t do it. To combat the loss of interest revenue from these good payers, Bank of America and Citigroup have decided to levy an annual fee ranging from \$29 - \$99 for cardholders who pay their bills in full each month.

Arbitrary Rate Hikes Credit cards companies are going to have a lot of restrictions on them next year with respect to hiking rates, so they are getting things in now. One example is my American Express Blue whose annual rate jumped from 6.99% to 9.99% in August of this past year. This is not because the Prime Interest rate went up or anything – no – Amex just decided to add 3% points because they can. Fortunately, I rarely carry a balance, so this did not impact me too much other than irritate me.

Inactivity and Low Activity Fees Some banks are going to charge people who hold credit cards but don't use them. Fifth Third bank recently implemented a \$19 per year fee for people who go 12 months without using their cards and Citibank is applying a fee to some consumers who have less than \$2,400 in charges in a year.

Scaled-back Reward Programs The reward programs that many users enjoyed have started to suffer as well. Card companies are cutting back on things like the amount of cash back rewards and increasing the number of points required to purchase things like free plane trips and hotel stays. As an example, this past year, American Express cut their Blue Cash reward from 1.5% of purchases to 1.25%. For someone who charges 100,000 a year, that means \$250 less in cash back at the end of the year.

Annual Fees In the early days of the charge cards, most people paid an annual fee for the convenience of not having to carry cash or checks with them. As we moved into the era of the credit card, banks lured consumers in with the promise of no fee cards in exchange for the opportunity to charge those same customers interest. Until recently, very few cards carried annual fees, the notable exceptions being the charge cards from American Express and Diners Club that require payment in full each month and as such do not derive income from interest payments. There were a few other exceptions including airline mileage credit cards and secured credit cards, but by and large, most people had access to cards that did not carry an annual fee. Since the new credit card law does not bar the imposition of annual fees, look for those to start cropping up on credit cards in the not too distant future.

Closing accounts without warning – This little trick is one thing that I recently discovered. Like many people, I had about five credit cards – an American Express Blue, a USAA Mastercard, a Discover Card, a Chase Visa card, and a Bank of America Mastercard. I really only use the first two actively. The Chase and the Bank of America were actually holdovers from years past. In both cases, these card accounts had originally been issued by other banks that had been acquired by Chase and Bank of America over the years. I recently moved and was in the process of updating all of my credit cards to reflect my new address and was surprised to find that both Chase and Bank of America had quietly cut me loose. Now, as I said, this is not a huge problem for me as I don't use these cards, but the loss of these cards definitely harmed my credit score.

Your credit score is made up of many factors, but two important ones are the overall age of your credit accounts and the ratio of available to used credit. In the first case, since both of these cards were older than my current ones, the cancelation of them reduced the average age of my credit accounts and hurt my credit score. In the second case, since these two card accounts had relatively high credit limits – the limit on one of them was over \$20,000 – having them drop off my credit file meant that the ratio of available credit to total credit dropped which also had a negative effect.

This incidentally is one of the insidious ways the card companies know they have you trapped. Sure, if you disagree with a change in their terms or interest rate, you can always cancel the account, but in doing so, your credit rating will take a hit.

Positive Features of Credit Cards

Okay, so far, this presentation has been fairly negative. Why don't we shift gears and have a look at some of the benefits provided by credit cards.

Aside from the convenience factor of being able to pay with plastic, some credit cards still can offer you benefits that make them preferable to paying with cash. Reward programs, while scaled back, are still an enticement. Let's face it – it may take you longer now to accumulate enough miles for that trip you want to take and you may get less money from a cash back card, but still, if you are going to spend money anyway, why not get something for it?

Mileage and Points Cards

The mileage/points card is perhaps the oldest model. Notable examples are cards issued in partnership with airlines and hotels as well as American Express's membership rewards program in which each dollar spent accumulates points that can be applied for free flights, hotel stays, gift cards, and more. These cards are the ones most likely to carry an annual fee, and the rewards tend to be paltry. American Express's membership rewards program for example returns an average of 1% of the total spent on the card. While they are still popular, I prefer the next group of cards, the cash back line.

Cash Back Cards

Cash Back cards return a specific percentage of spending in the form of credits to your statement. When Discover Card debuted in 1985, it offered a cash back program in which each year, some percentage of your annual spending was returned as a cash dividend. Since then, many other companies have jumped on the bandwagon offering a bewildering array of cash back schemes. What makes things confusing is that many cards have tiered cash back levels depending on the merchants you visit. American Express's Blue Cash for example, offers 5% cash back for purchases made at gas stations, grocery stores, and pharmacies as well as 1.25% back for purchases made elsewhere. Discover now offers the Discover More Card which has a base cash back of 1% as well as a 5% tier for purchases made at certain classes of merchants. The interesting part is that the merchant classes change each quarter. So, for example, during the months of January – March, the 5% tier includes travel purveyors such as Airlines, Hotels, Cruises, and rental cars. In the second quarter, the tier changes to Home and Fashion categories, etc. To maximize your cash back, you need to pay close attention to the changing premium calendar, but if you can tailor your purchases to their schedule, 5% is a fairly nice amount to get back at the end of the year.

Dedicated Savings Cards

The third category of reward cards was pioneered by I think General Motors some years ago and featured a savings account of sorts in which a certain percentage of each purchase was set aside in a

special account and could be used to purchase a GM car. Since then, other companies have followed the model such as the Disney Company which accumulates Disney reward dollars that can be spent on Disney merchandise and vacations. These cards tend to offer higher percentage accumulations than standard cash cards but limit where you can spend your earnings. Some cards like the current GM credit card gives you a choice – you can either accumulate 3% of purchases towards a new GM car or elect 1% in cash back.

Cards with Travel Privileges

Another benefit provided by some cards is travel privileges. For example, American Express offers its Platinum Charge Card which carries an annual fee of \$450. In return for this fairly steep price, cardholders have access to a number of travel related benefits such as free entry to certain airport lounges, free companion air tickets, concierge services, automatic elite level at hotel chains and a number of other things. While the price may seem steep, bear in mind that many airlines now charge upwards of \$400 a year for access to their lounges, so for a frequent traveler, the Platinum Card may actually represent a savings over purchasing these things separately.

The Bottom Line

Okay, so in this segment, we've taken a look at both the good and the bad of the credit card scene today. In the final analysis, let's face it, credit cards are here to stay, and if managed carefully, the good easily outweighs the bad.

The trick is to be an educated consumer. Understand the terms and conditions of your card as well as the ramifications of changing from one card to another. If you don't have a card that pays you back, I would suggest taking a look at some of the cards out there and doing some of your own comparison shopping. Google things like credit card ratings, credit card guides, etc., and you will find a wealth of information about the various card options available to you. One great site is Bankrate.com which has a ton of great information about all kinds of credit including a credit card finder that you can use to find the best card for you depending on your particular needs.

Above all, the ideal thing is to use credit cards wisely. If you choose to carry a balance, make sure you keep things under control and are not in a position where you would be seriously harmed if either interest rates or minimum payments go up. Credit card financing should never be used as a long term option unless you absolutely have to. Try to find other avenues for credit such as equity loans and the like. Otherwise, put off discretionary purchases indefinitely. Ask yourself for example if you really need a brand new big screen TV right now. Be vigilant as well. Miss a payment and you might find yourself with a 30% interest rate. If that happens, you are going to be paying credit card companies for a long time. Frankly, it kills me when I think how much money I wasted on interest payments when I carried a sizable credit card balance. Better to defer non-emergency items and keep the money in your pocket, not Citibank's.

I hope that you have found this segment to be useful. If you have any questions, certainly drop me a line a feedback@mindofmen.com and I'll do my best to answer them. With that, I think we are about out of time, so Mike, why don't you take us out.