How to Deal with Credit Card Debt

by Daniel Leibsohn

Introduction

Debt is one of the largest issues facing many Americans. We often do not earn enough money to cover the monthly costs of basic living – housing, food, health care, transportation, children's costs, etc. As a result, we may need to borrow money to make ends meet. Some people may have either more difficult or easier access to debt sources and these sources can have varying loan terms with higher or lower rates, shorter or longer length of the loan term and other loan terms such as fees, late payment levels, etc. When people with lower incomes also have bad credit, the terms available to them, if they have any access at all, often are very problematic. When bad loan terms are combined with a lower income level inadequate to meet basic needs, the result can be a long-term debt circle/trap that becomes very difficult to get out of.

Credit cards are one such source of individual debt. They are not available to everyone, for example if someone has defaulted on credit card or other debts in the past or if some or all of the total debt has been assigned for collections. Other people may have a low credit score and can qualify only for a bad credit card that has high rates, high fees and a low spending cap. Still others only may qualify for a secured credit card. As a result, many people have credit cards with both various terms and conditions along with a total amount of debt that can be very burdensome.

The amount of total credit card debt in the U.S. reached an all–time high of $870 billion in December 2018. The average American owes over $5,500. A little over 41% of Americans have credit card debt and the highest balances are carried by people in the Northwest and West Coast, as the average balances vary a great deal among states. Delinquencies are increasing again after falling for a few years since the Great Recession. The total amount of interest earned by credit card companies is estimated to reach $122 billion in 2019 up from $113 billion in interest paid in 2018. ("How Fed Rate Hikes Change Borrowing and Savings Rates", Nick Clements, magnifymoney.com, June 14, 2019.) Including fees, the total earnings grew to $180 billion in 2017 according to Bernie Sanders.

Credit Card Debt Impacts and Payment Strategies

The impacts of too much credit card debt can be damaging in several different ways. The interest payments can add up to a great deal of money over the repayment period. If late payments have accrued, the interest rate may be increased further and there are likely to be late payment fees. And, if the card holder continues to use the card, the total debt keeps increasing along with the amount of interest owed.

As a result, many people get to a point where they can only make the required minimum monthly payments. When this is the case, it can take many years to pay off a debt. For example, assume a $1,500 credit card debt with a minimum payment of $30 per month (2% of the outstanding balance). With an 18% interest rate and if the original $30 minimum monthly payment is maintained throughout the repayment period, this loan will take 94 months (7.8 years to repay) and the credit card holder will pay $1,293.35 in interest over the period plus repaying principal.

And these results are obtained with relatively favorable assumptions: the minimum monthly payment of $30 is higher than some minimums. (Different institutions use different formulas to determine the size of the minimum payments – Bank of America charges the greater of $25 or 1% plus fees and interest, for example.) The 18% rate could be increased if any payments have been missed; and if there are any late payments, there will be late fees and interest to pay as well. Also, the minimum payment for the first payment was maintained throughout the repayment period in this example rather than reducing the minimum payment each month as a small amount of principal is repaid monthly. If the revised minimum payment is used each month, the repayment term is much longer and the interest paid is much higher.

To see the impact of alternative terms, assume for example a minimum payment of $25 per month instead of $30 on the loan in the example above; the interest paid will be $2,366 over 155 months, or 12.9 years. If the payment goes down to $20 a month, the debt will accrue negative amortization – the interest paid will not be enough to cover the amount of interest due and the deficiency will be added to the principal balance. And, if you have surpassed your credit limit for the month (say $1,200 instead of the $1,500 debt), there usually is a fee for that misstep too. Finally, if cash advances are used, their rates are typically higher than the rate for charged items on the credit card.

The standard minimum monthly repayment fee is a crucial area of focus. This payment used to be 5% of the outstanding balance in the 1970's; however, when the card companies saw that the card holders could have reduced pressure while the companies would be much more profitable, the minimums were reduced to around 2% by the early 2000's. ("Credit Card Minimums: Perfectly Calibrated to Keep You in Debt", Claire Tsosie, Nov. 7, 2016, Nerdwallet.)

In some cases, making minimum monthly payments can take up to 20 or 30 years to repay, depending on the requirements. If minimum monthly payments instead of fixed monthly payments are made, it would take 232 months (19.3 years) to repay the $1,500, 18%-interest loan, and the total interest paid would be $2,897. Or, this same loan with a fixed monthly payment of $23 would take 258 months to repay, or 21.5 years, and the total interest payments would be $4,414.

On the other hand, making a monthly payment slightly above the minimum payment allows the card holder to repay the debt much more rapidly. The table below shows all these different scenarios where the impact of more rapid repayment clearly can be demonstrated. So contrast these minimum payment scenarios with making monthly payments even slightly higher than the minimum required, or $40 in this example:

Credit Card Balance	**Interest Rate**	**Fixed Payment**	**Months to Repay**	**Years to Repay**	**Interest Paid**	**Savings**
$1,500	18%	$30	94	7.8	$1,293	
$1,500	18%	$40	56	4.7	$ 721	$572
$1,500	18%	$25	155	12.9	$2,366	
$1,500	18%	$23	258	21.5	$4,414	

So it is very important to pay as much over the monthly minimum as possible.

Here is another example shown in the table below: a credit card balance of $5,000, with an 18% APR, and minimum payment as 2% of the credit card balance. Making fixed payments set by the minimum payment for the first month, it would take 7.8 years and $4,311 in finance charges to pay off this debt, not including any fees incurred over the life of the credit card balance. Increasing payments to $125 a month would allow a pay-off of the same debt in 4.6 years and with $1,774.42 spent in interest.

Credit Card Balance	**Interest Rate**	**Minimum Payment**	**Months to Repay**	**Years to Repay**	**Interest Paid**	**Savings**
$5,000	18%	$100	94	7.8	$4,311	
$5,000	18%	$125	62	5.2	$2,693	$1,618
$5,000	18%	$240	26	2.2	$1,040	$3,271
$5,000	14%	$100	76	6.3	$2,547	$1,764
$5,000	23%	$100	168	14	$11,740	($7,429)

The impact of paying off even faster also is evident. If affordable, a monthly payment of $240 could repay this debt in a little over 2 years with a total of $1,040 paid in interest and a substantial savings of $3,271. The impact of a lower rate also is clear. If this card holder's credit score is better, the rate can be lowered. In this example, a 14% rate with $100 monthly payments results in a 76-month repayment period (6.3 years) instead of 94 months (7.8 years) and interest paid of $2,547 instead of $4,311.

Your credit card statement is required to show how long it will take to pay off the debt using the minimum payments. Additionally, there are many credit card calculators on the internet that will help with determining how fast the debt can be repaid with different levels of payment, how much total interest is paid with these different monthly payments, etc. (For example, see https://www.bankrate.com/calculators/managing-debt/minimum-payment-calculator.aspx which includes both minimum payments and fixed payments.)

These calculations can get tricky. That is because each minimum monthly payment may include some amount of principal repayment each month. When that occurs, the next minimum monthly payment goes down because it is set as a percent of the remaining principal. This method results in much longer repayment terms and a much higher amount of paid interest. So it is critical to keep paying the debt at the same actual monthly dollar amount or higher throughout the repayment process rather than re-setting the monthly payment lower as each payment is made.

Using the minimum monthly payments results in much longer repayment periods and much higher total interest payments. There are other repercussions from too much credit card debt and/or late or missed payments. First, your credit score probably will fall. 35% of your score depends on making payments on time. It is crucial to make payments on time and not miss any payments. It is damaging if you can only make minimum payments on the debt as you will be judged less likely to be able to be a good risk for other debt; but even if you make minimum payments, they should be made on time and no payments should be missed.

And another 30% of the credit score is based on the utilization rate on your card – the percent of the credit maximum that you have charged on the card; this rate should not be more than 30% -- and preferably lower – to positively impact the credit score. For example, if your credit access line is $5,000, you should not carry more than $1,500 (30% of $5,000) on your balance the next month; if the amount, and therefore the percent, is higher, it can negatively impact your score. It is likely that your score will fall when you are in a situation where you are paying only the minimum monthly payments because the utilization rate is likely to be too high.

If you have missed two consecutive payments – i.e. if you are late for 60 days – the card company may be able to increase the rate on your card (check your agreement with the card company to determine the specific policy). If you default on your credit card, the interest rate you pay can increase to as high as 30%. Now, look at the same loan in the table above – $5,000 with a $100 monthly minimum payment – but with an increased rate of, for example, 23%. This loan requires 168 months or 14 years (compared to 7.8 years) to repay and the amount of interest paid is $11,740 (compared to $4,311) or an extra $7,429 in interest.

If someone has this type of situation on more than one card, the impact is further multiplied. If the same person continues this pattern for several years or decades, the impact grows. So it is not just one card and one debt that typically is the issue. It can be many cards over many years along with other debts. In these situations, the extra interest that has to be repaid can be extremely burdensome and have a great impact on someone's life.

In addition, if your credit score falls, it can increase the rates you have to pay on other loans, such as car loans or mortgages which often are determined by your credit score. There is a very great impact on how much you pay for these loans depending on how you handle your credit card and other debt and what your resulting credit score is. The impact on someone's life becomes even greater in this situation and can be repeated over many decades.

The examples above showed how much interest the card holder has to pay over the course of repayment when only the minimum payments are made. If you still have to use your credit card while making these minimum payments, the total debt amount escalates quickly as does the minimum monthly payment; when this situation occurs, the debt becomes more burdensome and the likelihood of late or missed payments exists – which brings more fees and interest payments.

Repaying Credit Card Debt

It clearly is beneficial to repay credit card debt as quickly as possible using as high a monthly payment as possible. But how can that be done when the credit card holder can only afford to make the minimum monthly payments or slightly higher than the minimum?

A process to get out of this trap is available. The first step is to review your budget, in-depth. At Community Development Finance, we use a very detailed budget on an excel spreadsheet to help people go through their expenses. A very helpful preliminary step is first to track every amount of money you spend for a couple of months and then separate these expenses into categories and add any other payments that you haven't made during the two months that you might make on a periodic basis – bi-monthly, quarterly, semi-annually or annually. Once someone sees the actual expenditures, it often becomes very clear where cutbacks can be made that will free up some extra cash each month that can be added to the minimum payments. In addition, there are ways to earn additional income; one of CDF's financial training workshops covers ways to earn money on the internet through a computer or phone by doing things such as taking surveys, playing video games, submitting grocery shopping bills, etc. Either or both of these methods combined can generate a certain amount of extra cash each month.

With this extra amount of money, someone facing debts can utilize either one of two different methods to repay debt: the Snowball or the Avalanche. For either one of these methods, all the debts need to be put on a spreadsheet of some kind. Since we are discussing only credit card debt, only the credit cards will be included in this discussion, but this method is used to create a strategy for addressing all debt and we will return to this method when we discuss all kinds of debt in a later blog.

For this spreadsheet, each credit card should be listed along with the total amount of debt, the interest rate and the minimum monthly amount required by the card company. With the Snowball method, the smallest debt amount is paid off first. So, list all the credit card debts starting with the smallest amount first leading down to the highest amount of debt. With the Avalanche method, the card with the highest interest rate is paid of first and the list is made by starting with the highest rate first and moving down to the lowest.

In either case, the minimum monthly payment will be paid on all the debts except the first one that is targeted. For the first one, take the extra funds you have made available through reducing your expenses through the budgeting exercise described above and/or the extra income created by some other method (using the internet as described above or an extra part-time job, selling some of your unused belongings, etc.) and add that to the minimum monthly payment for the first targeted credit card debt. Then pay that debt off as soon as possible using these higher monthly payments. Then, when that debt is repaid, use the payment amount from repaying the first debt plus the minimum payment amount on the next debt to repay the second debt. And so on until the debt is repaid.

The Snowball method uses the smallest debts first as repayment targets. This approach gives a sense of accomplishment as you watch the smaller debts fall off the list. The Avalanche method pays off the highest interest rate debts first; these debts may be higher amounts and may take longer and results may not be seen as quickly. But the total amount of interest paid can be smaller using the Avalanche method.

For example, assume credit card debts in the following amounts and terms:

Amount	Rate	Minimum Payment
$750	15%	$25

$2,000	20%	$30
$3,500	25%	$30

For the Snowball method, you would start with the $750 card debt. The minimum monthly payment of $25 would be added to the additional income created by re-budgeting or adding more income of, for example, $150 per month for a total of $175 paid per month. This first debt could be repaid in about 5 months. Then, take the $175 monthly payment used to repay the first debt and add the minimum payment from the next smallest debt of $30 for the $2,000 debt for a total monthly payment of $205. This debt could be repaid in 11 months. When that occurs, take the $205 paid on the $2,000 debt and add in the minimum payment that was being made on the last debt of $3,500 for a total monthly payment of $235. This debt could be repaid in about 19 months and then the holder should be free of the $6,250 credit card debt in 34 total months.

The Avalanche method would start with the highest interest rate debt or the $3500 balance. Using the $175 monthly amount available, this debt would be repaid in 27 months. Then the $2000 debt would be repaid using $205 per month and it would be repaid in 11 months. The last debt of $750 would be repaid in 4 months. This method took longer in this example, and the interest paid was greater than the amount using the Snowball method. In other situations, the amount of interest paid using the Avalanche method will be smaller. The holder can figure out the results ahead of time and make a decision based on interest saved, the amount of time required, and the type of psychological results that are considered more desirable.

Other Repayment Options

There are other ways to attack repayment of credit card debt that can be undertaken in combination with one of the above methods or used alone:

- Transfer the debt to a zero-interest card. The rate will stay low or zero for a pre-determined amount of time, maybe 6 to 24 months; during this period, pay off as much of the debt as possible – preferably all of it. Be aware that there often are fees for these transfers that can be up to 5% of the outstanding balance; it probably is best not to pay more than 3%, if that. In any case, if there are fees, run the numbers to determine that the amount paid in fees will be lower than the interest you would have paid if you stayed with the older card(s). If not, do not transfer to the new card. In addition to the transfer fees, there may be credit score limitations on these offers as they typically are available to people with good credit. In addition, the rate that starts after the zero interest period may be higher than the rate you are presently paying so you will want to have the debt repaid by the end of the zero-interest period. Finally, if any payments are missed, the zero interest rate may no longer be available. So be careful with an option that looks good on the surface in the short term but may be damaging over the longer term; be certain to research these issues and make an informed choice. One approach is to keep making these shifts to another zero interest card when the present term expires if you need more time to repay and these other factors would make it useful to make these switches. These zero interest accounts represent losses for the credit companies.

> Credit card issuers make up for the rate hike with the automatic rise in variable back-end rates, as well as the increasing spread between the prime rate and what consumers pay on new accounts. They can also increase other fees, like late payment fees or balance transfer fees to keep long 0% deals viable. ("How Fed Rate Hikes Change Borrowing and Savings Rates", Nick Clements, magnifymoney.com, June 14, 2019.)

- Find an online lender and consolidate the debt with this lender. Here, all the individual credit card debts are consolidated into one loan, often at a lower rate and fixed monthly payments. (There may be credit score limits on these loans though.) Sometimes, you can negotiate with the credit card companies and lower the debt amount if you have the funds to pay them quickly which, in this case, would be available with the consolidated loan. This may be especially true if the debt is in collections and the credit card company has sold the debt to another company for pennies on the dollar, making negotiations much easier. But beware. There are many online lenders that have rates and terms much more difficult that credit cards – higher rates, long loan terms, high fees, and lower monthly payments but higher interest payments over the full loan term.

- A similar approach can be used with debt management companies. All the debt can be transferred to one of these companies that will require only one monthly payment while they make the credit card payments. But here too, you have to be very wary about many of these companies which often try to scam borrowers. Check them out thoroughly. And do not work with any company that asks for up-front fees. Typically, the appropriate companies are nonprofit organizations that help you create a budget and offer other financial counseling services for little or no fee. They should be accredited (e.g. Council on Accreditation), set the terms acceptable to you in a contract, protect your privacy and not push or rush you into working with them.

- Talk to a local bank or, more likely, a credit union. If you have not defaulted on the credit cards and have no or few collections, your credit score may still be high enough to obtain a loan from a mainstream institution (usually after 6 months or some specified period of time of membership in a credit union). So be certain to check with the institution about its credit score and other requirements for a personal loan before moving any of your accounts. Credit unions tend to charge much lower interest rates if the borrower's credit score is in a higher range. Even if your credit score is too low for a loan at this time, it could be useful to join a credit union right now and work to raise your credit score (see the credit score discussion in the next section); then, at a later time when your score has increased, you will be ready to work with a credit union and will not have to wait for the introduction period.

- Negotiate with the credit card companies. Sometimes, they will lower their rates. You can also try to increase the spending cap or limit in order to lower your utilization rate, as described below.

- If you are paid on a bi-weekly basis, set up automatic credit card payments on a similar schedule rather than monthly. This can result in making two extra payments per year and, if the monthly payment is roughly the same, the debt will be paid off faster.

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Using Credit Cards to Increase Credit Scores While Paying Off Debt

A bad credit score can be very costly. Many rates may be attached to credit scores; some mortgages, car loans, credit card rates and others are lower if the credit score is higher or they are higher when the credit score is lower. This can cost a lot of money over the years.

For example, consider a $5,000 amortizing car loan with a 5-year term.

With a High credit score:	$5,000 loan at 8% for 5 years
	Payment = $101.38 per month
With a Low credit score:	$5,000 loan at 26% for 5 years
	Payment = $149.70 per month
DIFFERENCES:	$48.32 per month
	$579.87 per year
	$2,899.34 over 5 years

The gap for credit cards can be less extreme, but burdensome nonetheless:

> For borrowers with high credit scores, the average rate was 17.73 percent last week (May 2019), compared with 16.71 percent a year ago. For those with poor credit scores, the average is now about 24.99 percent, compared with 23.77 percent a year ago. "Sanders, Ocasio-Cortez want to cap credit card interest rates at 15 percent", Renae Merle, Washington Post, May 9, 2019.

Now, imagine if you have similar loans at different times during your lifetime and imagine you also might have much larger loans, such as a larger car loan or a mortgage. The amount of additional money spent on interest rates when you have poor credit can create a substantial financial burden on you and your family over your lifetime.

Use of your credit cards can impact your credit score positively or negatively. A credit score tends to be comprised of the following elements:

- 35%: Payment History. Making payments on time
- 30%: Amounts Owed. Utilization rate – keep total debt to 30% of the card's credit limit.
- 15%: Length of Credit History. How long the consumer has had a credit history.
- 10%: Types of credit used, or credit mix. Use both lines of credit (e.g. a credit card) and installment loans (home mortgage, car loan, etc.).
- 10%: New Credit. Opening a lot of new credit sources.
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So, you can create a strategy with your credit cards and other debt to improve your credit score:

- Always pay on time, even if it is the minimum.
- Try to pay more than the minimum payment for credit cards.
- Maintain lower utilization rates on credit cards, i.e. do not use over 30% of the stated debt limit on each card, as determined at the end of each month. The lower the better.
    - Pay off as much of the debt as possible if the utilization rate is over 30%.
    - Ask for increased credit limit on your cards to lower the utilization rate, but be very careful about not increasing your spending as a result.
- Length of Credit History
    - Keep older cards if possible, rather than newer ones.
    - Try not to close credit cards, especially the major onces without a good reason.
    - If you don't use your cards very often, try to use your credit cards occasionally – every month or two, even for small amounts, in order to keep them active.
- Types of credit or credit mix. Try to maintain a mix of amortizing credit (e.g. car loan, mortgage) and an open-ended line of credit (credit card);
- New Credit
    - Try not to open many new credit sources at the same time
    - If needed, space them out over time.
    - Limit hard inquiries. Make certain that anyone checking your credits gets your permission first.
- Other issues
    - Check your credit scores periodically so you can track changes and the reasons.
    - Dispute any errors you find and get them corrected.
    - Check for identity theft and fraud and take corrective steps immediately.
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Follow these steps with your credit card use and your credit score should increase. It is very difficult to find out many of the definitions and structures behind credit scoring and the three major agencies – Transunion, Equifax and Experian. However, some information does exist:

Several years ago, FICO also allowed us a peek behind the curtain and showed us exactly how badly common credit mistakes can mangle your credit score. A few examples of mistakes and their effects that FICO revealed at that time include:

- **Maxed-out card**: This mistake costs 10 to 30 points for someone with a 680 FICO score, and 25 to 45 points for someone with a 780.
- **30-days-late payment**: 60 to 80 points, and 90 to 110 points
- **Debt settlement**: 45 to 65 points, and 105 to 125 points
- **Foreclosure**: 85 to 105 points, and 140 to 160 points
- **Bankruptcy**: 130 to 150 points, and 220 to 240 points

The higher your score, the more points you'll lose due to such mistakes. Keep in mind that a perfect FICO score is 850, and you'll generally need a score of at least 730 to 760 to get the best possible rates on loans, depending on the lender. ("The True Cost of Bad Credit", Stacy Johnson May 18, 2017.)

Again, the impact of mistakes or avoidance of issues with credit cards can have a large impact.

Final Tips

- If your credit is very bad and no credit card is available, consider using a secured card. It can help rebuild credit and lead to a full service credit card.
- Cards issued by department stores and other stores tend to not be a good deal in general. They often have higher rates and sometimes lower spending caps. Many department stores are now using profits from credit cards to prop up their falling sales as they face the digital onslaught and, in some cases, massive debt run up by their new private equity owners.

> At Macy's, the money from branded credit cards accounted for 39 percent of the company's total profit of $1.9 billion last year (2016), up from 26 percent in 2013, according to an analysis by Morgan Stanley.….At Kohl's, the profit from plastic totaled 35 percent, up from 23 percent, over that same period. At Target, it made up 13 percent of total earnings, up from 11 percent in 2013. ("Profits From Store-Branded Credit Cards Hide Depth of Retailers' Troubles", Michael Corkery and Jessica Silver-Greenberg, New York Times, May 11, 2017.)

And these cards can have a high rate as noted in the same article: "In some cases, customers end up owing more in interest than the original bill. Many store cards carry rates around 30 percent."

- Credit card companies also can play various tricks:
    - The advertising can offer very low rates in large letters, but use terms like "as Low as" or use an asterisk to describe much higher rates depending on different factors such as credit score. Read the fine print.
    - Business credit cards may seem like a good deal, but they can be problematic too. They may require support by the holder's personal credit, not the business's. They also don't have some of the legal protections that personal credit cards do; so there may be higher rates and fees and other surprises.
    - Bonuses offered, such as cash back or airline miles, may be tied to difficult goals such as spending a certain amount in the first few months of holding a new credit card.
    - Many card offers appear to be tailored for each specific consumer and labeled as "Important" or "Pre-Approved". But these are just advertising gimmicks and each person still has to go through the full approval process.
- Know the signs of having too much credit card debt and too much debt in general. If possible, pay off the credit card bill each month, as between 30% to 35% of credit card holders do.
- Pay in cash if you can and keep your credit cards at home except for unusual situations and large charges. Try to limit use of credit cards whenever possible.
- Automate the payments if possible and if it is comfortable for you to do.
- Combine a good cash-back credit card with discounted gift cards and rebate websites to save money on your purchases.
- Beware of scams. Do not give out credit card or other personal or financial information over the internet, email or the phone.
- Pay credit card bills as soon as they are received. Many of us have been taught to pay bills by the end of any grace period and that holds true for most bills. But credit card payments are determined by the average outstanding daily balance. Card holders pay for each day the debt is outstanding. So, unless you pay off your card each month, it is better to make whatever payment that you make as soon as possible after receiving the bill rather than waiting.
- Try to watch the economic changes to understand how they impact credit card and other personal debt. For example, FED interest rate increases can have a large impact on rates paid, especially credit card debt where the rates typically are tied to increases in the prime rate or some other measure. "When rates are increased by 0.25%, the monthly minimum due on a credit card will increase $2 for every $10,000 of debt.". ("How Fed Rate Hikes Change Borrowing and Savings Rates", Nick Clements, magnifymoney.com, June 14, 2019.) This may seem like a small number but these small changes in the minimum payments can have a large impact, as shown in the tables above.

Conclusion

Credit card debt can be a huge issue for most of us. We are pressured by society's values to buy things and lead certain lifestyles. But the typical American may not earn enough to support these lifestyles and many do not earn enough to cover basic monthly costs. Nevertheless, credit has been made available relatively easily to allow us to support these lifestyles. But then, it is possible to get into problematic or even deep debt issues. There are ways to address these issues and keep credit card and other debt within workable limits.