CHAPTER 7

Dueling with the Devil: Credit Cards and Student Loans

The biggest source of financial woe for most consumers is juggling credit card and student loan obligations. Credit card companies want to keep you indebted through easily manipulated contracts, and the new credit card law has only made things worse. Both credit cards and student loans may carry variable rates that will shoot up during periods of inflation. Options are limited, but there are ways of fighting back.

Why Credit Cards Aren't Worth the Plastic They're Printed On

You know what a contract is. Two parties enter into a binding agreement enforceable by law, for their mutual benefit. I run a farm and you run a restaurant. I agree to sell you eggs at so-much a dozen, and you agree to buy them.

You'd never enter a contract that the other party can change any time they want, whereas you have no rights to change anything, would you?

But do you know what's in your credit card contract? A few years back, Consumers Union took a stab at summarizing a typical contract in plain language. Updated to reflect changes in credit laws, I think today it might read something like this:

> Dear Credit Card Customer,
>
> Thank you for running up such an enormous balance. That low interest rate we promised you? We can raise it at any time, whenever whimsy strikes. If you don't like it, you can just take your business elsewhere.
>
> Want to transfer a card balance to us? Good. We'll charge you a balance transfer fee that you probably don't know about until it's too late because you didn't read the fine print. But we won't charge you any inactivity fees if you fail to use your card—that would be against the law. Instead we'll hit you with a big annual upfront fee for the privilege of even having a card.
>
> You have to get your payment to us 21 days from when we mail you the bill. Mail problems in either direction are now *your* problem. We'll cheerfully process your payment on the day we receive it—if we receive it before 9:01 a.m. Otherwise we'll process it the next day and charge you a late fee. Oh yeah, and our "bank" is open Sundays and holidays. Too bad if the post office didn't deliver your payment until Monday.
>
> If your payment is late even once, we'll charge you a $39 fee. Over limit? Expect an over limit fee. Cash advance? Cash advance fee. Spending money overseas? We'll take 3 percent of what you spend as well.
>
> So thanks, valuable chump, ah, strike that, I mean "customer." We look forward to servicing your account for a long, long time. . . .
>
> Sincerely,
>
> Your Credit Card Issuer[1]

Pretty one-sided, right? And all the credit card company has to do to change the interest rate you pay is send you a notice.

When superinflation hits, what do you think the credit card companies will do?

Don't Expect the New Law to Save You

While the recently passed Credit Card Act of 2009 has reigned in some of the worst credit card abuses (or at least made them more transparent), it's also introduced new tricks for card issuers to get your money.[2] The banks, after all, are desperate, because the Card Act is estimated to have killed almost $400 million a year in card fees.[3]

Interest rate hikes must now be preceded by 45 days' advance notice—unless you make a late payment, in which case all bets are off. If the bank changes the terms to something too odious for you to live with, you can opt out —turn in your card and take five years to pay off your balance under existing terms.

Of course, then you will have lost use of that card. But perhaps you will be eligible for a new "subprime credit card"—at a higher rate, of course.

Credit card companies used to be specific about what kind of infractions would trigger changes in interest rates, but increasingly they favor vague terms and conditions:

"New credit card terms are now almost like mysteries when it comes to figuring out what could cause your interest rates to increase and by how much," says Reed Allmand of Allmand Law. "The only way to combat this problem is to pay your balance every month and to pay it on time."[4]

Most credit card companies have now shortened the time-to-pay to the statutory 21 days, and have introduced tricks to cause late payments, like keeping open their banks on Sundays and holidays when your mail can't possibly be delivered.

How to Outwit the Credit Card Companies

Because credit card companies can change the terms of the "agreements" you sign with them by simply giving 45 days' notice, holding debt on credit cards when superinflation arrives is a formula for disaster. You can be sure that whatever the inflation rate shoots up to, your credit card rate will shoot up even higher.

The best way to outwit the credit card companies to opt out of their game. Opt out now, while rates are relatively low, pay down and pay off credit cards, and switch to debit cards instead. Debit cards have all the convenience of credit cards and none of the associated risk. Like credit cards, you can use them to keep track of your expenditures, buy things over the Internet and even rent cars.

(Of course, you can't use debit cards to overspend or make impulse purchases—but that's a good thing, right?)

How to Be a Bad Credit Card Customer

If you aren't in an immediate position to pay off your credit cards, create a plan to pay them down. Credit card companies will hate you because they want to keep you in debt. Here are a few strategies to pay off your cards faster.

- Pay more than the minimum payments. The minimum payments are calculated to keep you in maximum indebtedness for periods as long as 30 years. Do you still want to be paying for your toaster oven 30 years from now?
- Consolidate balances onto a low-interest-rate card. Make sure you know what you're getting into, though, because most low interest rates will disappear with a single late payment. Most banks now charge a balance transfer fee. Bankrate.com offers a calculator to make sure that it's actually cheaper to switch cards: http://www.bankrate.com/calculators/credit-cards/credit-card-balance-transfer-calculator.aspx
- Borrow against life insurance. Typically you'll be replacing a funny-money, the-rate-is-whatever-we-say payment with a fixed payment at fair rates. When superinflation hits, you want to be in fixed payments.
- Stop paying and use the leverage to renegotiate. Oddly enough, when credit card companies aren't getting regular payments, they become much more amenable to negotiating terms with you. After all, they are unsecured creditors. That means their prime legal recourse is to ding your credit report. (They might sue you as well, but in most states you'll get far better terms to pay off your judgment than you would paying 22 percent interest rates.)

Goose Your Contracts with a Gold Clause

If you are a small business owner, you are in the enviable position of protecting the value of your investments against future inflation by negotiating a gold clause payment.

A gold clause allows the creditor to collect payments in a specified amount of gold or gold equivalent. For instance, your contract might call for payment in 100 ounces of gold. If the value of gold in dollars goes up 10 times between now and the end of your contract, your creditor will have to pony up 10 times the dollars to pay you in the contracted amount of gold.

You will have effectively killed the risk of inflation.

Gold clauses were outlawed in the United States by the Gold Reserve Act of 1934, when FDR went looking for an excuse to end the gold standard.[5] But Congress reinstated their use in 1977 in accordance with 31 U.S.C. § 5118. In 2008, the U.S. Court of Appeal (Sixth Circuit) reaffirmed the use of the gold clause in *216 Jamaica Avenue, LLC vs. S&R Playhouse Realty LLC.* In that case, the Court held that a 1912 rental contract containing a gold clause was enforceable, raising the tenant's rent from $35,000 per year to $1.4 million per year.[6]

Further Reading on the Gold Clause

Before you write a gold clause into your next contract, learn more about the practice and its pitfalls from Henry Mark Holzer. Holzer is professor emeritus at Brooklyn Law School and he wrote the authoritative book on the subject: *The Gold Clause: What It Is and How to Use It Profitably* (San Jose: IUniverse .com, 2000).

How to Use Inflation to Discount Your Student Loans

Part 2's principle reminds us that future money is cheap money. If you can pay a fixed obligation you incur today (say, a $50,000 student loan) at some point in the future when the dollar is worth less, you are effectively getting a discount on your loan.

With student loan payments, that's easy if you qualify for a deferment. A deferment allows you to pay your federally subsidized loan back in the future without incurring any interest payment in the meantime. Here are a few ways you can qualify for a deferment:

- Go back to school.
- Get a medical internship or graduate fellowship.

- Become unemployed or financially unstable.
- Volunteer for the military or the Peace Corp. s [ea]
- Have a child who requires parenting.
- Teach at a low-income school.[7]

Deferment conditions vary somewhat, depending on the type of loan a student carries (e.g., Stafford or Perkins Loans). The Federal Student Aid site has created ~~this~~ handy chart summarizing the types of deferments available: (see Table 7.1). [ea]

lc

a [ea]

Don't confuse a deferment of your student loan with a forbearance. A forbearance allows you to begin paying your loan in the future, but accumulates interest, sometimes at an adjustable rate.[8]

Table 7.1 Student Loan Deferment Conditions

	Stafford Loans		
Deferment Condition	Direct Loans[a,b]	FFEL Loans[a]	Perkins Loans
At least half-time study at a postsecondary school	YES	YES	YES
Study in an approved graduate fellowship program or in an approved rehabilitation training program for the disabled	YES	YES	YES
Unable to find full-time employment	Up to 3 years	Up to 3 years	Up to 3 years
Economic hardship (includes Peace Corps service)	Up to 3 years	Up to 3 years	Up to 3 years
Service listed under discharge/cancellation conditions	NO	NO	NO
Borrower is on active duty during a war or other military operation or national emergency and if the borrower was serving on or after Oct. 1, 2007, for an additional 180-day period following the demobilization date for the qualifying service	YES	YES	YES
For a borrower who is a member of the National Guard or other reserve component of the U.S. Armed Forces (current or retired) and is called or ordered to active duty while enrolled at least half-time at an eligible school or within six months of having been enrolled at least half-time, during the 13 months following the conclusion of the active duty service, or until the borrower returns to enrolled student status	YES	YES	YES

Source: StudentAid.ed.gov

[a] For PLUS Loans and unsubsidized Stafford Loans only principal is deferred. Interest continues to accrue.
[b] Direct Loan borrower who had ~~on~~ outstanding balance on an FFEL Loan first disbursed before July 1, 1993, when the borrower received his or her first Direct Loan, is eligible for additional deferments.

lc lc an [ea] lc lc lc

Check with your lender for details, but avoid a forbearance at all costs if you qualify for the more desirable deferment.

Beware of Prepaid Tuition Guarantees

that [ea]

If you're investing in a state 529 plan ~~which~~ purports to offer prepaid tuition at a state university at some time in the future—beware. The contract you think you are entering into may not be as ironclad as you think.

Nineteen states offer these popular investment accounts that "guarantee" future tuition for money paid in now, according to www.finaid.org, a student financial website. (Another 33 states offer college savings plans but without prepaid tuition guarantees.[9])

The prepaid plans purport to give parents peace of mind, "entitling" contract holders to receive future tuition and fee benefits, notwithstanding rises in college tuition prices.[10] Plan managers invest the money in markets to grow the funds intended to pay the future costs.

But with tuition rates increasing at twice the general inflation rate and stock markets wobbling in an era of increased volatility, some 529 funds are in trouble.

(see Figure 7.1) [ea]

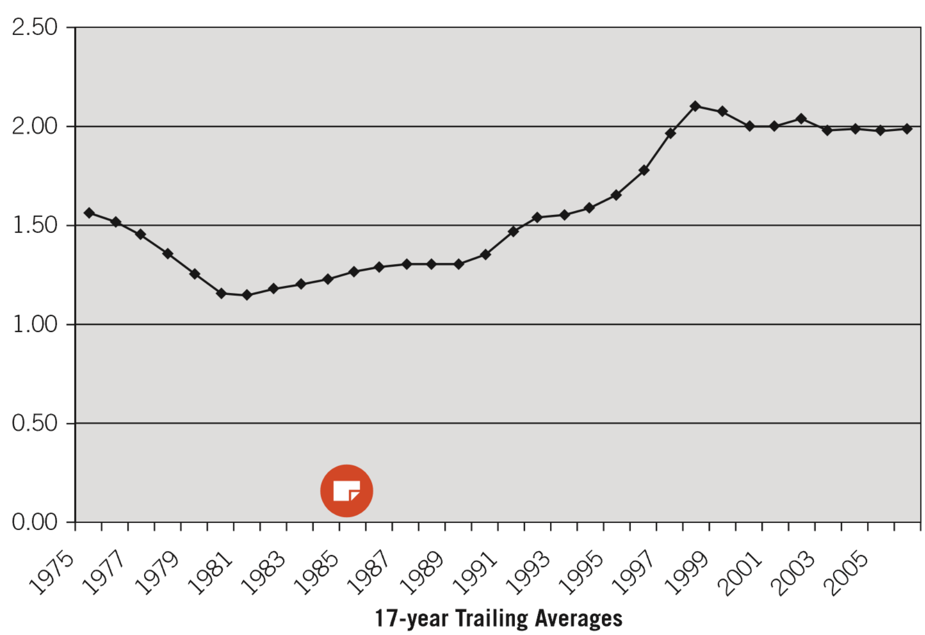

Figure 7.1 Ratio of Tuition Inflation to General Inflation

Source: finaid.org

Surprisingly to those relying on the 529 plans to lock in tuitions, only two of the 19 states (Florida and Texas) actually back their plan by the full faith and credit of the state.

Three others (Kentucky, Virginia, and West Virginia) have laws in place that set up special escrow accounts to meet shortfalls or require state institutions to accept less than full tuition if push comes to shove.

None of the other states offering prepaid tuition 529s actually require themselves to deliver the promised prepaid tuition, although three states (Illinois, Maryland, and South Carolina) do make legislatures "consider" a financial bailout for faltering plans.

529 Tuition Plans: Let the Buyer Beware

"None of [fourteen] states offering prepaid tuition 529s actually require themselves to deliver the promised prepaid tuition . . ."

In Illinois, a Crain's Chicago Business investigation revealed the state plan to be underfunded by 20 to 30 percent.[11] So far, the state legislature seems unwilling to ride to the rescue, putting parents on the hook for tuitions they thought they had already paid for.

A similar story is unfolding in Alabama, where Patti Lambert invested more than $100,000 in prepaid tuition for her eight grandchildren, only to learn that the plan may run out of money in 2015.

Said Ms. Lambert: "Everything about the way the plan was promoted implied that it was backed by the state."

How much are those implied guarantees worth? Consider this comment by Representative Jim Durkin of Alabama.

In a state beset by unbalanced budgets and unfunded pension obligations, "I guess the response would be, 'Get in line,'" he told the *New York Times* about families looking for their "guaranteed" tuitions.[12]

Let the buyer beware.

Key Points

- Contracts with credit card companies are subject to whimsical, one-sided changes for small infractions of rules—or no infractions at all.
- The Credit Card Act of 2009 eliminated some fees while instituting for banks a whole new way to play the game.
- Be a bad credit card customer: Pay down your balances quickly, or borrow against life insurance to change high-interest variable rates to a low fixed rate.
- Small businesses can once again write legally binding gold clauses into contracts.
- Use inflation to discount your student loans through a deferment loophole; don't confuse loan deferment with loan forbearance, where interest will continue to build up.
- States can default on prepaid tuition plans, even if you think you've locked in your child's tuition.