DOLLARS & Sense

Family Financial Education Foundation

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Robbing Peter to Pay Paul

There's a very famous building in London, England, known as St. Paul's Cathedral. St. Paul's is where the wedding of Prince Charles and Princess Diana took place. This cathedral was designed by Christopher Wren, the famous architect who also designed the famous Trinity College library at Cambridge University, and The Royal Observatory at Greenwich, England, where Greenwich Mean Time originated.

There is another famous church in London. It is called Westminster Abbey, but the full name is The Collegiate Church of St. Peter at Westminster. Westminster has been the seat of the government of England for almost a thousand years.

If you take a tour around St. Paul's Cathedral, the tour guide will most likely tell you that money was taken from the government's allotment for Westminster Abbey, or St. Peter at Westminster, to pay for construction of St. Paul's after the earlier cathedral on the site was destroyed by a fire in 1666. Your guide will also probably tell you that this is the origin of the expression "rob Peter to pay Paul." Makes sense doesn't it? This familiar phrase means to take something from one person or thing to pay a debt to another. The phrase can be used literally or figuratively. A figurative way of using the phrase could refer to something such as sacrificing one's health to work overtime.

A literal use of the phrase describes what many people have been doing for the last couple of years so they don't lose their homes. In order to avoid foreclosure, homeowners are using their paycheck to make the mortgage payment and using their credit card to pay for everything else. For some people, this is the last resort before losing their home. As long as they can keep the house, they figure they'll worry about paying the credit cards off later. But this is a dangerous risk to take.

For example, Dick and Jane Smith had worked out a new repayment schedule with their mortgage lender two different times, but they were still falling behind on their monthly house payments. Even with the new repayment schedules, they couldn't manage to come up with the monthly amount due. Not only that, they have maxed out all their credit cards, spending to the limit on basic needs. Now all they can afford to do is make the minimum monthly payments. The stress is getting to be more than they can bear.

Their original mortgage loan was an adjustable rate loan (ARM). The payments were higher than Dick and Jane could really afford, but they figured that over the next two years, their situation would improve and they would be able to handle it. At the end of the two years, the payment was scheduled to increase even higher, but they were sure Dick would have a raise before then and they would be okay. Both in their thirties, they are still hoping something will happen so that things will get better, and they'll be able catch up, but they're not exactly sure what that something will be.

According to counselors providing debt counseling to home owners around the country, an alarming number of Americans are in the same situation as Dick and Jane. They risk losing their homes to foreclosure because they have piled up a second mountain of debt on top of the first. Why? Rising mortgage payments and tougher standards for refinancing have led desperate borrowers to use credit cards to cover their basic survival needs while trying to keep up with their house payments.

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What You Should Know Before You Transfer a Balance

No bank or lender wants to give money away. Their ultimate goal is the same as any other business, i.e., to make money. Sometimes we find it necessary to help them with their goal when emergency circumstances arise and we are forced to borrow money or extend our available credit.

This can result in having a credit card on which you "carry a balance," in other words you make monthly payments to pay off the amount you have charged on the card. This makes you a perfect candidate for balance transfer offers. Some offers are for a significantly lower interest rate, others are only a small amount lower than the interest rate we already have. Before you make the balance transfer jump, make sure the odds are in your favor.

An often misunderstood procedure you need to be aware of is how a bank allocates your credit card payments when you have balances at more than one interest rate. If you study the fine print in the offers you receive, you will discover that most, and usually all, of the credit card payments you make once you authorize a balance transfer will go toward the newly transferred lower-interest balances.

The reason for this is that these balances cost the most money for the credit card issuer. They are essentially lending you this money for little or no charge. Credit card companies call this a "free ride." They are willing to do this because they are betting that you will not be able to pay the balance off in the length of time the low interest is in effect and will, therefore, eventually be paying a higher interest rate.

Having your monthly credit card payments going to your lowest interest rate balance is not in your favor for two reasons:

The Pros and Cons of Balance Transfers

One of the most appealing alternatives that can arrive in the mail when you are struggling to pay your credit card bills is an offer to transfer your balance to a low-interest or even no-interest card. Sometimes this offer is from a credit card you already have. The offer includes the option to increase your available credit and transfer balances from other high-interest credit cards you carry to this one card and pay low or no interest for a period of time, which varies depending on the company making the offer.

The Pros

The pros of good balance transfers, i.e., transfers that will actually benefit you, are simple. First, the reduced interest rate allows you to reduce your monthly finance charges immediately. Second, the reduced finance charges mean you can save money by paying less for finance charges and applying that saved money to paying off the principal balance. If you stick with this goal, you can pay your credit card debt off faster.

The Cons

First, the people who are in the most need of help with high-interest rates are, unfortunately, usually not the ones who receive offers for good balance transfer options. The offers high-debt sufferers receive often charge high fees to transfer balances or only offer the promotional interest rate for a very few months, e.g., 6 – 12 months. In most cases, only credit cardholders who have excellent credit scores are eligible for the best transfer rates and the longest promotional lengths of time. And they don't need it. If you have a lot of credit card debt and/or high balances, your credit score is probably not the best, which makes it difficult for you to have the option of a really worthwhile balance transfer.

A second "con" is that the balance transfer rates are not guaranteed. They can change faster than lightning. If you miss just one payment on any of your loans or credit cards, you can lose that low transfer rate immediately on your transferred balance and a high interest rate kicks in. This nasty practice is called universal default. You can find it in that small-type booklet that comes with your credit card agreement. The interest rate can go as high as the state you live in allows. ■

1. If you already have a balance existing on your credit card and you are paying an interest rate on this balance that is higher than you are paying on the transferred balance, this balance will continue to increase every month as none of your payment is going toward this balance. The monthly interest just keeps adding up, and each month you will be paying interest on the interest as well as on the original balance.
2. Any new purchases you make are not included in the new low interest rate. These purchases will add to the total due at the higher interest rate and will increase that balance, which again is not being paid off until the lowest interest balances are paid off.
3. While it is true that other types of debt can be transferred to credit cards, including car loans and appliance loans, you may end up paying significantly more for these loans if you don't pay the transferred amount off in the allotted time.

When Is It an Advantage to Transfer a Balance?

1. When you have no previously existing balance on the credit card you wish to transfer to.
2. When you know for a fact that you can pay the transferred balance off fully before the low-interest time period expires.
3. When you can cut up the card you are transferring the balance from and never use it again. ■

If you find this information helpful, please be sure to pass it along to friends and family.

Tips for Assessing A Credit Card Offer

1. Read the disclosure statement or terms/conditions carefully. What are the post-promotion rates and terms?
2. Is there a balance transfer fee?
3. What are the late payment and over-limit fees?
4. What is the grace period? You'll want a 25-day grace period if possible.
5. Is there an annual fee? Ideally, find a card with no annual fee.
6. Look around for the lowest rate you can find. Watch out for bait-and-switch offers that talk like you'll be able to transfer a big balance and then only give you a $500 credit limit once you've been approved. ■

Word Diversion

Take a break from your day to solve the puzzle below. Look for the words listed under the puzzle and circle them when you find them. All the words are used in this newsletter.

N	O	I	T	U	B	I	R	T	N	O	C	W	G	C
H	N	T	Z	C	H	B	M	O	R	T	G	A	G	E
X	I	U	R	V	R	E	P	A	Y	M	E	N	T	K
E	I	B	E	Z	X	V	K	X	E	P	G	O	J	D
Y	L	Y	T	V	S	N	R	E	F	S	N	A	R	T
D	A	C	S	P	R	E	T	I	R	E	M	E	N	T
C	W	B	N	I	Y	O	T	D	Y	Q	I	M	Y	A
V	A	F	I	L	T	U	B	A	L	A	N	C	E	H
Q	R	M	M	V	L	Z	Y	I	F	L	A	T	A	Q
S	D	W	T	F	A	K	F	U	U	I	V	R	O	K
J	H	M	S	S	N	U	S	A	R	M	D	L	G	J
Q	T	U	E	K	E	O	P	E	V	S	Z	P	I	T
F	I	A	W	O	P	O	T	I	H	F	W	B	S	H
V	W	P	T	C	I	E	V	I	I	Y	H	F	V	K
H	H	E	C	R	P	T	P	D	E	G	S	A	Y	R

peter
balance
repayment
contribution

retirement
hardship
transfer
mortgage

westminster
paul
withdrawal
penalty

Borrowing from a Retirement Fund

Billy Jones borrowed $10,000 from his 401(k), cutting his retirement savings in half. He felt like he had no other choice. Although employed full-time, he and his wife couldn't keep up with their monthly expenses after MasterCharge reduced the limits on their credit cards. As banks around the country tighten their lending standards due to a faltering economy and food and gas prices continue to climb, more and more people are resorting to the same measures as Billy and his wife. They are drawing out of their retirement accounts just to get by and help make the mortgage payments and put food on the table. This is a worrisome practice to financial planners as it means people are using their retirement money now and lowering their standard of living when they retire. Large plan administrators like Great-West and Fidelity are seeing big spikes in hardship withdrawals and loan requests. In the past, these numbers traditionally varied little. The Joneses also sold a diamond ring and some camera equipment and are trying to get rid of their expensive car lease. They are hoping to pay off their 401(k) loan in two years.

If you're thinking of making the same decision as the Joneses and contemplating dipping into your 401(k), be aware of some of the risks involved.

At 40 years old, if you borrow half your 401(k) savings and stop paying into your account for 5 years, you risk losing nearly a fifth of what you would have saved by retirement. If you take a loan but repay the loan in its entirety and continue to pay into your 401(k) account while you are also paying the loan back, you will achieve 99% of your original retirement income by the time you reach 62 years old. If you take a loan and repay the loan but STOP paying into your 401(k) account for 5 years while you are paying the loan back, you will only achieve 82% of your original retirement income by age 62. Loans from 401(k) plans that are repaid suffer no tax consequences, but if you default on the loan and are unable to repay it, you then become liable for the tax penalty on the money you withdrew.

Dipping into your 401(k) for a hardship withdrawal that is not paid back can carry tax risks because hardship withdrawals are taxed as income and are subject to a 10% penalty if taken when you are under age 59½. Because dollars you pay into your 401(k) account are pre-tax, meaning they are subtracted from your paycheck before your tax is calculated, they become taxable when you withdraw the money. So if you are in a 25% tax bracket and you are younger than 59½ when you withdraw the money, you pay 25% tax plus the 10% penalty—you lose 35% of the money you withdraw. For example, if you withdraw $10,000, you will lose $3,500 of that money.

Most companies who offer 401(k) plans for their employees limit hardship withdrawals to the categories stipulated by the Federal government, i.e., medical expenses, purchase of home, foreclosure or eviction prevention, repair of storm damage, tuition payment, and funeral expenses. But even if your needs fit into one of these categories, you will still be charged the tax and penalty if you take a withdrawal. In addition to the taxes charged, many companies prevent employees from resuming 401(k) contributions for at least 6 months after taking a withdrawal.

Many people think they will pay back the withdrawal through increased contributions once hard times have passed, but unfortunately this optimistic attitude doesn't always materialize into reality. If you are able to find a way to survive your financial difficulties without taking a withdrawal from your 401(k), research has shown that you will have 13% more in retirement funds than those who took a withdrawal. ■

Robbing Peter to Pay Paul

(continued from page 1)

The U.S. Federal Reserve provided data for May 2008, which showed that consumer revolving credit, mostly credit cards and charge cards, increased $6.6 billion, or 7.0 percent, in a single month. Of even more concern was Federal data showing an alarming increase in late credit-card payments.

It is important that you do all you can to avoid getting into the same dilemma as Dick and Jane. Your FFEF counselor will help you find ways to avoid having to rob Peter to pay Paul. This newsletter includes some things to think about as you make good financial decisions in the coming months. ■

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If you know of someone who would benefit from this information, please pass this newsletter along.