

Battle Royal: Credit vs. Debit

Which card to use? A combination of both is the best one-two punch.

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In this era of tighter credit, many Americans have adopted a new frugality -- and the debate over credit versus debit cards is getting louder. When Kiplinger's published an article last November pointing out that debit cards come with fewer protections against fraud than credit cards, we were inundated with comments from readers. Most took exception to our "poor advice" and "scare tactics." Some readers advocated cutting out plastic altogether and learning to pay with cash again.

Tom Petro, chief executive of Fox Chase Bank, a community bank outside Philadelphia, tends to sympathize with the cash crowd, but he also sees reason to use both credit and debit cards. He calls the poor plastic habits of many Americans "death by a thousand swipes." The trouble is, says Petro, when you use a card, you don't feel as though you're spending real money. "Families get themselves into trouble one latte at a time," he says. "Then, when people feel bad, they go out and spend more."

Petro speaks from firsthand experience. He and his wife, Kris Messner, a business consultant, climbed out of debt in the late 1980s with a series of small savings, such as brewing their own coffee instead of buying it in the morning and making do with one car. As a result of his experience, Petro thinks both credit and debit cards belong in your wallet -- but each has its place. Debit cards, he believes, should be reserved for groceries, gas and other daily essentials. But he doesn't disdain credit-card use -- as long as you can pay the balance in full each month.

Of course, the approach you take depends on your spending habits and personality. Do you spend and spend and then hope for the best when you open your monthly statement? You may be a good candidate for a debit card, which limits you to money you have in the bank. Out-of-control credit users tend to carry a balance and are more vulnerable to late fees -- often at \$39 a pop. The average household with at least one credit card has nearly \$10,000 in debt, according to the Nilson Report, an industry newsletter.

On the other hand, "if you are a person who doesn't overspend, or you have so much money coming in that it doesn't matter, then the credit card's the winner," says Karen Lee, a financial planner in Atlanta. Plus, a credit card offers more protections against fraud and problems with merchants, so it's a good way to pay for big expenditures and online purchases.

Proponents on both sides are passionate about their positions, with good reasons for embracing one method and rejecting the other. But it's fair to say that the best strategy is probably a smart combination of both.

When credit cards win

One of the biggest benefits of using a credit card is the grace period. If you pay your bill in full every month, you can purchase now and pay later with no interest charge. That lets your money sit in your bank account and earn interest (as measly as rates are these days) and gives you more flexibility with your cash flow.

You can goose the earnings on your cash by putting it into a high-yielding checking account at an online bank, community bank or credit union, where you're likely to earn a higher interest rate than you would at a large, brick-and-mortar-based institution. Then there are the rewards programs. Debit-card issuers are starting to offer their own perks, but credit-card companies generally have the best deals. For savvy card users, the benefits can really add up. Frank Remund, a fee-only financial planner in Beaverton, Ore., recently used his Visa Signature card to buy a Samsung high-efficiency front-load washer. After calculating what he'd earned in cash-back rewards -- not to mention what he saved using a Lowe's discount coupon and a state tax credit -- Remund says he paid a total of \$380 for the washer, which retails for nearly \$800. Plus, by using his Visa card, he doubled the warranty period.

Which rewards card suits you best depends on your spending priorities. To find the most appropriate card for your situation, go to a credit-card comparison site, such as LowCards.com or Credit.com, which just introduced "expert picks" that highlight the most consumer-friendly cards. BillShrink.com has a quiz that will help you customize your search based on the way you use credit, your redemption preference and the category in which you spend the most.

Scott Bilker, founder of DebtSmart.com, uses his rewards credit card from Wawa, the convenience-store chain, when he shops. That earns him gift cards to buy gas at Wawa. Bilker also puts his business expenses on the card to maximize his rewards. He prefers credit to debit because of the purchase protections in the case of a dispute. But he warns that users who depend on credit cards should track their spending so they don't over-swipe and rack up more debt than they can handle. "Discipline is part of any plan," he says.

Secure your swipes

Another big advantage of using a credit card is security. If someone steals your credit card and goes on a spending spree, your liability is capped at \$50 (Visa and MasterCard assume all liability for unauthorized purchases). With debit-card theft, the automatic legal protection isn't there. If your debit card is stolen, you have to report it within two days to get the same \$50 limited liability. Report it after that but within 60 days and your liability goes up to \$500. Beyond that period, you face unlimited liability.

That said, if you've been a good customer, most banks will credit your account after a couple of days. But to be safe, sign for purchases rather than using your PIN. When you do so using a Visa or MasterCard debit card, the transaction goes through their networks (signing produces more revenue for the banks than using a PIN), and you have zero liability in case of fraud. Likewise, if you have a dispute with a merchant -- for example, you're not satisfied with the quality of an item you've purchased or there's a billing error -- you may have an easier time working out a solution if you paid with a credit card. Say you bought a laptop that was damaged in shipping. Call your credit-card company to complain (if you can't solve the problem over the phone, you may have to resort to filing a formal dispute with your card issuer, in writing, within 60 days). You won't owe anything while the issuer resolves the complaint. If, however, you used your debit card to pay for the laptop and you want to return it, the law doesn't protect you -- although some banks may go to bat for you to help you get your account reimbursed.

The upside of debit


If you prefer to pay as you go, or if you're trying to get out of debt and control your spending, a debit card is the way to go. You don't have to worry about overspending because the money gets sucked out of your account right away. But that can be a pitfall if you are in an overdraft-protection plan. Then the bank covers your debit but slaps you with a hefty fee. The largest banks impose a \$35 charge, on average, each time you overdraw. (New federal regulations that take effect July 1 for new accounts will require banks to get your permission before enrolling you in an overdraft-protection plan.)

For added discipline, use a debit card for small items. Stay on top of your spending by keeping a written tally of your purchases -- just as you would with an old-fashioned check register -- or by signing up with your bank to get notices of your account balance. Big banks, such as JPMorgan Chase, will send you free notices via e-mail or text message, and online banks usually offer the same service. If someone steals your card and starts spending your money, such alerts will serve as a red flag. And tracking your account balance will also help you with budgeting.

Give yourself credit

Above all, you need to be practical, particularly when it comes to managing your credit score. Credit-card payments are reported to the credit bureaus, but debit-card use is not. Your payment history makes up a full 35% of your FICO score (the most widely used credit score), and that number determines the interest rate you will be offered when you apply for a mortgage, an auto loan and other credit, such as a small-business loan.

Think strategically before you close an account. A chunk of your score depends on how much of your available credit you have actually used -- known as your credit-utilization ratio. So shutting down credit lines could hurt your score by raising the percentage of remaining credit that's in use.



If you feel the need to cancel some cards to take control of your finances, don't do it just before you apply for a major loan. And keep your oldest card open because another part of your credit score is determined by how long you've had your accounts.

Now that the new credit-card rules have taken effect, it's more important than ever to read the fine print of your credit-card agreement. Issuers say the rules could cost them billions of dollars, so they're looking for new ways to raise revenues, and most have revised their terms over the past few months. As you look over your revamped agreements, keep an eye out for notices of new annual fees and higher late fees. Citibank just added a \$60 annual fee to many accounts, which will be credited back to the account if cardholders charge \$2,400 during the year.

The same goes if you're considering signing up for a new card. In the fourth quarter of last year, the volume of offers sent out by credit-card companies via direct mail jumped 47% from the previous quarter, reports Mintel Comperemedia, a research firm. That marked the first increase in three years, but the offers included more annual fees and higher rates.