
Consumer Decision Making Contest

1997-98 Study Guide

CREDIT CARDS

Some of your friends may have credit cards already. When they enter college, most students are offered credit cards by credit card companies. At first glance, a credit card gives you freedom to buy something on the spur of the moment--without worrying if you have enough cash in your pocket. It makes shopping look incredibly easy with just one payment due at the end of the month.

But if you talk to friends or adults about using credit cards, you may find that there are drawbacks. Some credit card users find they've spent too much money on too many things. Some can't pay all their credit card bills--or can't pay their bills on time. And, those who have trouble paying back their debts may find they can't borrow money when they want to make a really important purchase--like a car or a house. The key to using a credit card wisely is knowing how to use it responsibly.

What To Look For

Finding the credit card that's right for you can save you a lot of money. Learning a few simple lessons about using and paying for credit can save you even more.

Many companies offer credit cards. They have different fees and interest rates, as well as a variety of services.

Most credit cards, such as Visa, MasterCard and Discover, allow you to pay only part of the amount you owe each month. You are charged interest whenever you have an unpaid balance. Charge cards, such as American Express or Diner's Club, require you to pay off the entire amount you owe each month, but do not charge interest.

Federal law requires credit card companies to disclose the following information on most application forms:

- **The interest rate on outstanding balances.** Interest rates are expressed in terms of a single percentage figure, the "annual percentage rate" (APR). The range of interest rates around the country is often large, from less than 8% to more than 20%. Usually the lower the APR the less you'll pay for credit.
- **Whether the card has a "grace period."** Most credit cards allow you to pay off purchases without being charged interest, by taking advantage of their "grace period." This is an amount of time in which you can pay off a debt without incurring finance charges. It is usually about 25 days.

To make use of a grace period, pay your bills in full each month by the payment due date. If you owe any money on your previous statement (referred to as

having an outstanding or previous balance), in most cases you will lose the benefit of having a grace period on new purchases for the current month.

Not all credit cards have a grace period. When you use a card with no grace period, the bank begins charging you interest on the day the purchase is made or the day it is recorded (posted) on your account, depending on the bank's policy. When a credit card does not have a grace period, there is no way to avoid paying interest on your purchases.

If you use a card that has a grace period (and you have no outstanding balance), you will not be charged interest until the next billing cycle. In addition, you won't be charged any interest if you pay off your balance in full during the grace period of that cycle.

(However, you will probably be charged interest on cash advances every day until you repay them.)

- **How interest is calculated.** There are many ways to calculate interest. Some companies use methods that result in much higher charges than others. More on this later.

- **The annual fee.** Many cards have an annual fee. You pay this fee every year that you have the card, even if you don't use it. Annual fees range from \$15 - \$35 on regular credit cards and from \$50 and up on a gold card. With more and more competition, some banks are offering cards with no annual fee.

The Cost of Credit

Most people don't realize how much they pay for credit. There are many factors that affect the cost.

The longer you take to pay off your balance, the more your credit card will cost you. You might even get confused because the amount you owe the credit card company never seems to go down, even though you make payments every month and haven't added any new charges.

This happens when you make only the "minimum payment" that the credit card company requires you to pay each month. Most of this money pays for interest. The amount you owe will not go down very much. To avoid this, and lower the amount of interest you will pay, pay more than the minimum payment. The more you pay the faster you will pay off your balance and the lower your interest will be.

A practice called "compounding of interest" also results in higher than expected interest. When you have an outstanding balance and don't pay it all off, the interest you are charged is added to the total amount that you owe the company. The next month, last month's interest is included in the balance used to calculate the interest you must pay. This increases the actual rate (called the "effective" rate) that you pay.

Many credit cards have interest rates of nearly 20%, while some are around 15% or as low as 8%. The differences in these rates can cost you a lot of money over the course of a year.

For example, suppose that every month during the year you owe the credit card company exactly \$1,000. The amount of interest you will pay will depend on the company's annual percentage rate:

	Interest Rate	Total Annual Interest Charges*
Bank A	8%	\$80
Bank B	20%	\$200

*Excluding compounding of interest.

Calculating Interest

The interest that you pay depends on the following factors:

•**The size of your "outstanding balance":**

the total amount of money you owe the credit card company, as shown on your monthly statement.

•**The method the credit card company uses to calculate interest.**

•**The interest rate charged.**

If your card has a grace period and you pay off the balance in full before the due date, you will not be charged interest. (If you made a cash advance, you will be charged interest on that advance.)

If you pay less than the full amount owed, you will be charged interest on all of your unpaid balance and on any purchases you make during the next month.

To calculate the interest you owe, the company must determine the size of your balance each day during the statement period. It may use one of several methods to calculate the interest:

•**Average daily balance, which includes any new purchases.**

The company determines how much money you owed each day of the month, and charges interest on that amount. It also charges interest on every new purchase you make during the month.

•**Average daily balance, excluding any new purchases.**

This is similar to the above method but more advantageous to you, because it doesn't include interest on purchases made during the month.

•**Two-cycle average daily balance.**

A few companies use the balance you owed over a two-month period. This means they include interest on purchases from the previous statement that you may have paid off immediately. This method can result in high interest charges.

•**Date of purchase versus date posted.**

Some companies assess interest from the date the purchase was made. Others wait until the date they received the charge, which is better for you.

Because the method of calculating interest can result in higher costs to you, it is important to read the fine print in your credit card agreement and choose a card with the method that works most in your favor.

If you don't understand the method used, ask the company for an explanation of it.

Minimum Monthly Payment

The "minimum monthly payment" is the smallest amount you can pay and still be a cardholder in good standing. Banks often encourage you to make the minimum payment, such as 2% of your outstanding balance or \$20, whichever is less. Some statements refer to the minimum as the "Cardholder Amount Due." (That is not the total amount you owe.)

If you pay the minimum, it can take years to pay off the debt, and you will pay a lot more in interest. Suppose you owe \$2,000 on a card with 19% interest and a 2% minimum payment. Paying just the minimum every month, it will take you 265 months-- over 22 years-- to pay off the debt, and it will cost you nearly \$4,800 in interest payments.

Doubling the amount paid each month to 4% of the balance owed would allow you to shorten the

payment time to 88 months from 265 months--or 7 years as opposed to 22 years--and save you about \$3,680.

If you don't pay anything, or pay less than the minimum you will be charged a late fee and will be subject to loss of your credit card. In addition, there may be a negative report to credit bureaus. That report could affect your ability to obtain credit in the future.

Some cards allow you to skip a payment without penalty. While this sounds like the bank is giving you a break, you will be charged interest during this period and will owe more in interest than you did before.

Costly Fees

Many people look for a card that doesn't have an annual fee, but did you know that there are other fees that can cost you more in the long run?

Late fees. Most cards charge a fee when payments arrive late, after the due date. Some banks wait a few days before assessing this fee, but many impose it the day after the payment was due.

Some companies have a set fee, such as \$10 or \$15, while others charge a percentage, such as 5%, of the minimum payment due. Just paying late fees twice in one year can cost you more than an annual fee.

To avoid late fees, mail your payment in plenty of time to arrive before the due date. If you pay your bill at the bank's branch or ATM, find out how long it will take to process your payment. Sometimes payments made at a branch or ATM are not credited for a few days.

Over credit limit fees. Most cards assess a fee if you charge more than your credit limit. These fees are charged each time you exceed your limit, so you could be hit with several of them during one billing period.

Most banks have a set fee, such as \$10 or \$15, while others charge a percentage, such as 5%, of the amount you are over your limit.

If you charge \$400 over your limit, with a 5% penalty, you will pay a fee of \$20. This is in addition to interest charges.

Lost card replacement fees. A few companies charge people whose cards have been lost or stolen more than once or twice. These fees are usually \$5 or \$10.

Cash Advances

A cash advance is a loan billed to your credit card. You can obtain a cash advance with your credit card at a bank or an automated teller machine (ATM) or by using checks linked to your credit card account.

Most cards charge a special fee when a cash advance is taken out. The fee is based on a percentage of the amount borrowed, usually about 2% or 3%.

Some credit cards charge a minimum cash advance fee, as high as \$5. You could get \$20 in cash and be charged \$5, a fee equal to 25% of the amount you borrowed.

Most cards do not have a grace period on cash advances. This means you pay interest every day until you repay the cash advance, even if you do not have an outstanding balance from the previous statement.

On some cards, the interest rate on cash advances is higher than the rate on purchases. Be sure you check the details on the contract sent to you by the card issuer.

Here is an example of charges that could be imposed for a \$200 cash advance that you pay off when the bill arrives:

Cash Advance Fee = \$4 (2% of \$200)

Interest for one month = \$3 (18% APR on \$200)

Total cost for one month = \$7 (\$4 + \$3)

In comparison, a \$200 purchase on a card with a grace period could cost \$0 if paid off promptly in full.

Which Card Is Best?

Deciding which card is best for you depends on the way that you will use it. For example, choosing a high interest rate card because it doesn't have an annual fee could cost you a lot of money. You could pay much more in interest than you save on the fee.

How do you usually use your credit card?

- **"I pay off my entire balance every month."**

If you pay off your balance every month you don't have to worry about interest rates, because you don't need to pay any interest. Your first priority in a card is to make sure it has a grace period. In addition, look for a card that has no annual fee.

MONEY SAVING TIPS

- Ask the card issuer if you can get a lower interest rate on your existing card for being a good customer.
- Keep track of the amounts you have charged to avoid a fee for exceeding your credit limit.
- Whenever possible, pay off the entire bill to avoid paying interest.
- Always try to pay more than the "minimum payment", to reduce your balance faster.
- Mail your payment as soon as you can to reduce the interest you owe and to ensure that you won't pay a late fee.
- Remember that leaving even a small balance can result in large interest payments the next month.
- If you have a problem with an item you purchased using a credit card, you may have additional consumer protection.
- Read all notes from your credit card company to spot changes in policies.
- Know when your bill usually arrives, and ask the company if you don't get one when you think you should.
- Save all receipts and compare them with your credit card statement.
- If you believe there is a mistake on your statement, contact your credit card company as soon as you can. Call the number listed on your statement.
- Always destroy the carbon part of any receipt that you sign, to help prevent misuse of your card number.
- If your card is lost or stolen, call your credit card company immediately. The maximum that you can be required to pay for unauthorized charges is \$50 per card, if you notify the credit card companies promptly.
- Never give your credit card number to an unknown caller.

- **"I sometimes have an unpaid balance at the end of the month."**

If you occasionally have an unpaid balance, choose a card with a low interest rate and a grace period. If you get a card that doesn't have a grace period, you will pay some interest whenever you use the card if you have an outstanding balance.

- **"I usually have an outstanding balance."**

If you usually have an outstanding balance, you should get the lowest interest rate you can find, because you will be paying interest every month. For you, the interest rate is more important than having a grace period or no annual fee. You won't benefit from a grace period because you have an outstanding balance. You can save more in lower interest charges than you could through a lower annual fee. But the best way to save money is by paying off your balance completely.

When shopping for a card, be sure to consider those that have "variable interest rates." These cards are tied to a particular "index" a figure that reflects changes in the cost of money. One common index is the "prime rate." The rates on these cards go up or down periodically, as those indexes change.

Variable rate cards often have lower interest rates than do "fixed rate" cards. (Rates on cards with fixed rates can also change, but they tend to do so less often.)

Credit card issuers who have very low rates receive large numbers of applications. As a result, they turn down many people who want their cards. But cards with lower rates are widely available to consumers who have good credit.

Payment Problems

Sometimes, because of overspending, illness, or other difficulties, you may find it impossible to pay your bills on time. If you ever find yourself in that situation try to work out a modified payment plan as soon as possible with those to whom you owe money.

Be cautious about turning to a debt counseling company to solve your debt problems. Avoid paying in advance until you find out what the company can really do. Before you sign any contract, check out the organization with the Better Business Bureau in the community where the company is located. A regional office of the Texas Attorney General's office can also provide you with some information if they

have had any reports about unscrupulous people operating in the state or your community.

Consumer Credit Counseling Services are non-profit counseling services. These services are located in many of the larger communities of Texas and offer clients financial counseling and assistance on repayment plans by working with your creditors. There might also be other non-profit financial counseling programs offered in your community by a university, military base or credit union. Use any and all assistance services rather than endanger your credit rating.

For more information about credit, ask your Consumer Life Skills Leader to present Lessons 10 and 18 from the Consumer Life Skills Leader Guide.

Also, see the following videos available from the Extension Service Audio Video Library:

VHS-777	Financial Responsibility
VHS-	Credit Cards: Living with Plastic
VHS-	Surviving in the Real World: Basic Skills: Dollars & Sense

Reference:

"Saving Money on Credit Cards", Consumer Action, 1992.

"Understanding Credit Card Costs", Consumer Action, 1994.

Prepared by Dr. Joyce Cavanagh, Extension Family Economics Specialist, September 1994.