Snapshots™

STARTING OUT:
CREDIT CARDS

CREDIT CARDS ALLOW YOU TO PAY IMMEDIATELY FOR YOUR PURCHASES WITHOUT HAVING TO CARRY LARGE AMOUNTS OF CASH. HOWEVER, CREDIT CARDS HAVE ALSO BEEN THE SOURCE OF FINANCIAL DISASTER FOR MANY PEOPLE DUE TO THESE SAME FEATURES.

With a credit card, you buy goods and services based on your promise to pay for these goods and services at a later date. The issuer of the card—the bank or whichever institution you get the card from—gives you a line of credit that you use to pay for your purchases, or as a cash advance. As you use the credit card, you are borrowing money and accumulating a balance, which is then charged interest. Each month, you are sent a statement indicating the purchases you've made with the card, any outstanding fees, and the total amount you owe. After receiving the statement, you may dispute any charges that you think are incorrect. Otherwise, you must pay a defined minimum proportion of the bill by a due date, or you may choose to pay a higher amount up to the entire amount owed. The credit issuer charges interest on the amount owed if the balance is not paid in full (typically at a much higher rate than most other forms of debt). In addition, if you don't make at least the minimum payment by the due date, the issuer may impose a 'late fee' and/or other penalties. To help avoid these charges, you can arrange for automatic payments to be made from your bank account every month.

Credit cards are easy to get from many sources and much of your financial well-being depends on using them wisely. Many offers for credit cards appear very attractive with 'free' gifts and benefits. It is often possible to receive a credit card even on a limited income, and not uncommon for people to carry multiple cards.

Companies offering credit cards earn most of their revenue from interest payments on delinquent accounts—those whose balances have not been paid in full by the due date. It's important to keep in mind that, while the cards are convenient, the interest rate on credit cards is generally high—usually in the 18% to 20% range, but can go as high as 29% particularly on cards offered by large retailers—and most issuers also charge an annual fee, usually in the $25 to $75 range but sometimes more.

The Costs of Not Paying Your Card

Far too many people fall into the trap of having multiple credit cards and only paying off the minimum balance required. Credit, especially for spur-of-the-moment purchases, can seem like 'free' money, particularly when only a minimum amount has to be paid every month. However, over time, the costs add up and can have a dramatic effect on your finances. Consider a simple example:

Assume ABC Credit Card has an 18% annual interest rate compounded daily and payable monthly, and you buy $3,000 worth of furniture on the card. The minimum payment required is 2% of the principal balance per month—in this case $60 (2% X $3,000).

The minimum payment required must cover the interest payable and any excess over this will reduce the principal. The first month's interest will be:

18%/365 days = .05% per day compounded for 30 days = 1.5%

1.5% X $3,000 = $45

Therefore, of the $60 minimum payment, $45 will go to paying interest and only $15 will go to paying down the principal. In other words, at the end of the month, you will still owe $2,985. If this example were continued using the same assumptions, it would take approximately 30 years to pay off this debt and you would be paying more than $7,300 in interest on a $3,000 debt over the lifetime of the debt.

As the example above shows, becoming trapped in a credit/minimum payment situation can have severe consequences for your current and ongoing financial well-being.

One technique to control your credit card use is to make an effort to only use credit cards for purchases that are large and not regular. For ordinary smaller purchases, using a debit card or cash can help impose discipline since the amount that you can spend is limited by your actual cash on hand.

This credit card payment calculator can help you determine how long it will take you to pay off your credit card debt and the total amount of interest you will pay over the lifetime of the debt.

Cash Advances

Many credit cards offer you the option of taking out a cash advance. It's tempting to treat this money as just another purchase on your credit card, but cash advances can be risky, expensive and throw you into debt if you don't quickly repay them.

That's because cash advances usually come with fees—from one to four percent of the amount of the advance. So, if you are taking out an advance of $500, you'll pay between $5 and $20 in fees to the credit card company. In addition, cash advances have higher interest rates than regular purchases. On top of that, most credit cards don't give you a grace period for cash advances, which means that interest starts accruing as soon as you take the cash from the ATM.

And don't forget about the ATM fee the bank charges you for using their machine. Depending on which bank's ATM you use, the ATM fee could add another $2 - $4 to the cost of your cash advance.

Before you consider taking a cash advance, make sure you read your credit card agreement to understand the terms and fees. Check your cash advance limit as it could be lower than your credit limit—exceeding your cash advance limit can lead to overage charges and even higher interest rates. If you don't understand something in your cardholder agreement, call a customer service representative and ask.

You can limit your costs by withdrawing only the amount of money you need. Control the temptation to take out a little bit more so you have extra cash on hand; doing so will only make it harder to repay the advance. Better yet, try to use cash advances only for real emergencies, such as unexpected (but necessary) car repairs. Avoid using a cash advance to pay for everyday items like groceries or gas.

Generally speaking, the need for quick cash is often a symptom of a bigger money management problem. Before you decide to take out a cash advance, consider some alternatives such as: a small loan from your bank or credit union; borrowing from a family member or friend; an advance from your employer; or speaking with a consumer credit counseling agency. A better strategy for managing unexpected expenses is to build an emergency fund so you have a cash reserve for those times when you need extra money outside of your budget.

Choosing the Right Credit Card(s)

There are literally dozens of credit card options and choosing the right card(s) can appear confusing and intimidating given the amount of features and incentives available. As a general rule, you should keep the amount of cards to a minimum; for example, you might have one card for personal use and one for business use. Here are some of the factors you should consider when choosing a credit card—and it always pays to read the fine print on the credit card documentation.

- The Annual Percentage Rate (APR) – This figure will determine how much interest you will pay if you carry a balance from month to month. If you plan to pay off the balance on the card every month (the ideal situation), then this bit of information is not as important as others. Still, you should consider the fact that there can be different rates charged for purchases, balance transfers and cash advances.

- Credit Limit – This is the maximum amount of money that you borrow on your card. Although a higher limit can seem attractive, you should start with a lower balance to ensure that you can manage the charges. The limit can always be increased later. This also imposes some spending discipline.

- Fees – There will be various charges associated with the card, such as an annual fee, late fees, over-the-limit fees, etc. Consider the likelihood of these fees occurring.

- Rewards and other Features – Most cards offer some sort of reward structure and you need to determine if it makes sense for you. For example, some cards will offer travel insurance as an added benefit, but you need to look at the details to see if the coverage is actually appropriate for your needs.

For any reward or benefit, you should determine whether the cost you are paying to receive the benefit through the card is worth the expense. In a given year, you may not actually use the benefit or you may be able to get it cheaper somewhere else.

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