8.8 Credit Cards

# Objective 1: Find the interest, the balance due, and the minimum monthly payment for credit card loans.

Using a credit card is an example of an **open-end installment loan**, commonly called **revolving credit.** Credit card loans require users to make only a minimum monthly payment that depends on the unpaid balance and the interest rate. Credit cards have high interest rates compared to other loans.

Methods for calculating interest, or finance charges, on credit cards may vary and the interest can differ on credit cards that show the same annual percentage rate, or APR. The method of calculating interest on most credit cards is called the **average daily balance method**.

**THE AVERAGE DAILY BALANCE METHOD**

Interest is calculated using *,* where *r* is the monthly interest rate and *t* is one month. The principal, *P*, is the **average daily balance**, the sum of the unpaid balances for each day in the billing period divided by the number of days in the billing period.

To determine the average daily balance:

1. Make a table that shows the beginning date of the billing period, each transaction date, and the unpaid balance for each date.
2. Add a column to the table that shows the number of days at each unpaid balance
3. Add a final column to the table that shows each unpaid balance multiplied by the number of days that the balance is outstanding.
4. Find the sum of the products in the final column of the table. This dollar amount is the sum of the unpaid balances for each day in the billing period.
5. Compute the average daily balance.



**CALCULATING AVERAGE DAILY BALANCE**

| ***DATE*** | ***UNPAID BALANCE*** | ***NUMBER OF DAYS*** | ***PRODUCT*** |
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# Objective 2: Understand the pros and cons of using credit cards.

| **ADVANTAGES** | **DISADVANTAGES** |
| --- | --- |
| * Use a product before actually paying for it. * No interest charges by paying the balance due at the end of each billing period. * Responsible use is an effective way to build a good credit score. * No need to carry around large amounts of cash. * More convenient to use than checks. * Offer consumer protections: If there is a disputed or fraudulent charge on your credit card statement, let the card issuer know and the amount is generally removed. * Provide a source of temporary emergency funds. * Extend shopping opportunities to purchases over the phone or the Internet. * Simple tasks like renting a car or booking a hotel room can be difficult or impossible without a credit card. * Monthly statements can help keep track of spending. Some card issuers provide an annual statement that aids in tax preparation. * May provide amenities such as free miles toward air travel. * Useful as identification when multiple pieces of identification are needed. | * High interest rates on unpaid balances. * No cap on interest rates. * The initial credit card interest rate is unlikely to go down and more likely to go up. * No cap on fees and issuers can hike fees at any time, for any reason. Read the fine print of a credit card agreement before signing up. * Easy to overspend. Purchases with credit cards can create the illusion of not actually spending money. * Can lead to financial trouble. Failing to pay the bill in full each month can result in serious debt. Fees and interest charges are added to the balance, which continues to grow, even if there are no new purchases. * The minimum-payment trap. Most of the minimum payment goes to interest charges and does not reduce debt. |

# Objective 3: Understand the difference between credit cards and debit cards.

Debit cards offer the convenience of making purchases with a piece of plastic without creating debt. The card is linked to a checking or savings account. Using the card immediately withdraws money from the account.

Debit cards may not offer the protection a credit card does for disputed purchases.

 Some banks provide **overdraft protection.**  The debit card won’t be declined for lack of sufficient funds, but there will be a significant fee for the overdraft which must be paid back.

# Objective 4: Know what is contained in a credit report.

Organizations known as credit bureaus collect credit information on individual consumers and provide credit reports to potential lenders, employers, and others upon request.

**INFORMATION CONTAINED IN A CREDIT REPORT**

1. Identifying Information: name, social security number, current and previous addresses
2. Record of Credit Accounts: details about all open or closed credit accounts, such as when each account was opened, the latest balance, and the payment history.
3. Public Record Information: bankruptcy information
4. Collection Agency Account Information: information about unpaid accounts that have been turned over to collection agencies
5. Inquiries: record of companies that have asked for this information

# Objective 5: Understand credit scores as measures of creditworthiness.

Credit bureaus use data from a credit report to create a **credit score** which is used to measure creditworthiness. Credit scores, also called **FICO scores**, range from 300 to 850, with a higher score indicating better credit.

Table 8.11 below lists credit scores and their significance.

| **Score** | **Creditworthiness** |
| --- | --- |
| 720 – 850 | Very good to excellent; best interest rates on loans |
| 650 – 719 | Good; likely to get credit, but not the best interest rates on loans |
| 630 – 649 | Fair; may get credit, but only at higher rates |
| 580 – 629 | Poor; likely to be denied credit by all but a high-interest lender |
| 300 – 579 | Bad; likely to be denied credit |