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Consumer and Family Sciences

Department of Consumer Sciences and Retailing

To Your Credit: Fact Sheet 2

Choosing the Best Interest Rate

EXPERT REVIEWED

Barbara R. Rowe, Extension Specialist

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http://web.aces.uiuc.edu/cfe/ccs/index.html

What is the interest rate on the credit card you use most often? If you don't know, you are not alone. Fully a third of all credit card holders can't answer that question. That means lots of money for banks and other lenders and less for consumers to use to buy goods and services. Choosing a credit card with the lowest interest rate can save you money. Forty-eight percent of all U.S. families had an outstanding balance on some type of credit card after paying their most recent bill. The median balance for these families was $1,900 on all cards, according to the 2001 Survey of Consumer Finances.

Finding a lower interest rate

Shopping for the best credit card value can be complicated. Different issuers of national bank cards such as VISA, MasterCard, and Discover charge different interest rates. They also use different methods to calculate finance charges. Under the federal *Truth-in-Lending Act*, creditors must disclose the interest rate or the Annual Percentage Rate (APR). The APR measures the cost of credit as a yearly interest rate. APRs on credit cards can vary from 8 percent to 21 percent or more. People considered to be a bad credit risk will usually be offered credit cards with higher APRs or annual fees.

If you are like most people, you sometimes carry a credit card balance from one month to the next. If so, the APR can make a big difference in the **real** cost of items you purchase. The following chart shows how much a $2,000 balance would cost you at different APRs if you did not pay it off right away.

Credit card lists

Web sites that allow you to search for credit cards with various features include:

- Credit Card Menu by gromco, www.creditcardmenu.com
- Credit Card Catalog, www.creditcardcatalog.com
- All Credit Cards Online, www.allcreditonline.com

Finance charges on a constant $2,000 balance

	6 months	18 months	36 months
21.0%	$210	$630	$1,260
14.0%	$140	$420	$840
8.9%	$89	$267	$534

Ways interest costs are figured

The effective rate on credit card purchases and balances can actually be much higher than those indicated on the previous page. Whether you paid last month's balance and whether you have new purchases can both affect your finance charges. In addition, different cards, even from the same issuer, can use different ways to calculate the interest charged on your combined carryover balance and new purchases.

The chart on this page compares different methods of figuring finance charges. In the example, the APR is 18% a year, or 1.5% a month. Using the various methods, the finance charge could be as little as $1.50 or as much as $6.

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The most common method for calculating interest or finance charges is the **Average Daily Balance Method**. In this method, the issuer calculates a balance for each day and multiplies this times the daily interest rate (1/365th of the APR). This is taken times the number of days in the billing period. A billing period can range from 28 to 35 days, depending on the days in the month and whether your billing or payment dates fall on a Sunday. If you carry a balance from last month, most cards do not have a grace period on any purchases made that month — you are charged interest from the first day you buy an item.

In the less used **Previous Balance Method**, your finance charge depends completely on last month's balance. Payments and purchases you make this month do not affect your finance charges. This method can be costly if you made a big payment and few purchases.

Some card issuers use the **Average Daily Balance Method** but exclude newly billed purchases. That method would cost less than the Average Daily Balance Method in months when you have new charges.

The **Adjusted Balance Method** takes into account payments you have made but not new purchases. You will often pay the lowest finance charges with this method.

The **"Two Cycle" Balance Method** costs you more than other average daily balance methods because it averages in higher balances from the previous month. Check with your credit card issuer for details.

Finance Charge Method	APR	Previous Balance	New Purchases	Payment	Average Daily Balance	Finance Charges
Average Daily Balance (with new purchases)	18%	$400	$50 on 19th of month	$300 on 15th of month	$270	$4.05 *
Average Daily Balance (without new purchases)	18%	$400	$50 on 19th of month	$300 on 15th of month	$250	$3.75 **
Adjusted Balance	18%	$400	Not applicable	$300	Not applicable	$1.50 ***
Previous Balance	18%	$400	Not applicable	$300	Not applicable	$6.00 ****

* [($400 x 15 days) + ($100 x 3 days) + ($150 x 12 days)] divided by 30 days = $270 x 1.5% = $4.05
** [($400 x 15 days) + ($100 x 15 days)] divided by 30 days = $250 x 1.5% = $3.75
*** $400 - $300 = $100 x 1.5% = $1.50
**** $400 x 1.5% = $6.00