Cost of Credit

Interest Rate

What are the finance or additional charges? The **interest rate (the APR)** is the percentage cost of credit on a yearly basis. This is key to comparing costs. The Truth In Lending Act doesn't set interest rates or other charges, but it does require that the lender disclose the terms of the credit plan so that you can "comparison shop" for credit. Other charges such as annual membership fees, points, and transaction charges are not included in the APR.

Interest Rate Example

Suppose you borrow $100 for one year and pay a finance charge of $10. If you can keep the entire $100 for a whole year and then pay back $110 at the end of the year, you are paying an APR of 10%.

But if you repay the $100 and finance charge (a total of $110) in twelve equal monthly installments, you don't really get to use $100 for the whole year. In fact, you get to use less and less of that $100 each month. In this case, the $10 charge for credit amounts to an APR of 18%.

Finance Charge Example

METHODS USED TO CALCULATE FINANCE CHARGES

The method used to calculate the balance on which you pay a finance charge makes a difference in the cost of credit.

Adjusted Balance

The adjusted balance method takes the amount you owed at the beginning of the billing period and subtracts any credits and any payments made by you during the period. New purchases are not counted.

Average Daily Balance

The average daily balance – one of the most common methods – adds your balances for each day in the billing period and divides that total by the number of days in the period. Payments and credits made during the period are subtracted and new purchases may or may not be included.

Two-Cycle Average Daily Balance

The two-cycle average daily balance method uses the average daily balances for two billing periods to calculate the finance charge. Payments and credits made will be accounted for and new purchases may or may not be included.

SOUND CREDIT CARD ADVICE

Pay off your credit cards each month. If you can't afford to pay off your credit cards each month, make the largest payment you can afford and pay the card off before you make another purchase.

The example below illustrates the value of this concept.

Example: Different Methods of Credit

Let's look at an example of how the different methods used to calculate finance charges can affect the cost of credit. Bankcard Holders of America (BHA) calculated the finance charges on one account four different ways. The account started with a zero balance the first month. The account holder then charged $1000 and made the minimum payment. The next month, the account holder charged another $1000 and paid off the balance due. The account's interest rate is 19.8%. The calculations resulted in these figures:

Method	Include New Purchases?	Payment

Average Daily Balance	Yes	$33.00
Average Daily Balance	No	$16.50
Two-Cycle Avg. Balance	Yes	$49.05
Two-Cycle Avg. Balance	No	$32.80

You can see by this example that the calculation method can cause the balance to vary widely. Since your finance charges are based upon your balance, you can end up paying a lot more for your credit – not because you get greater value in what you purchased, but because the calculation method takes more money OUT of your pocket.