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Credit: How it works

Credit is the ability to make a purchase now without paying until later. One common type of credit is the credit card, which provides immediate buying power. Other types of credit include mortgages, student loans, and home equity lines of credit. You can use credit to make purchases that you could not otherwise immediately afford. The players are you, the seller, and the creditor. For example, swiping a credit card acts as an agreement to pay back the credit card company (creditor) at a later date for covering the business's (seller's) bill.

After making a purchase on credit, the time between the end of a statement and the payment due date is known as a grace period. The time between making a purchase and paying back the creditor is known as the cash float. You also have a specified amount of money available for spending, known as a revolving credit limit. If a credit card has a credit limit of $1,000, you can spend up to $1,000 with this card. If you make a $300 purchase, you have $700 left on the credit limit. Paying back $300 of principal (borrowed money) replenishes the credit limit.

Credit card users can either pay back the credit balance in full, in part, or with a minimum payment. This minimum payment must be enough to pay all of the monthly interest plus part of the principal. Keep in mind that paying the minimum keeps you out of trouble with the creditor but will not help pay off debt. You may end up spending significantly more than if you had paid for your purchases outright.

The length of the grace period is a useful comparison point if you know you will pay off the balance each month. This feature has no impact if you pay back your balance over time.

The most important comparison for people who carry a credit card balance is the finance charge, or interest. Any balance not paid by the statement due date accrues interest. New purchases made after the statement's due date will also accrue interest if you have an unpaid balance. The monthly interest rate is calculated by dividing the Annual Percentage Rate (APR) by 12. For example, an 18% APR divided by 12 equals an interest rate of 1.5% charged on your balance each month.

The balance can be calculated three ways when determining the amount of interest due. The most common way is by calculating the average daily balance. This approach calculates what is owed on each day taking into account any payments made to the creditor during the statement period. The adjusted balance method is cheapest and charges interest only on the ending balance after any payments made to the creditor. The previous balance method ignores any payments made to the creditor during the past month and charges based on the full amount owed at the start of the period.

When selecting a credit card or other source of credit, read the fine print carefully. Credit companies are required by law to provide a disclosure amidst their promotional materials which specifically outlines the APR, grace period, any annual fees, and other important information.

Next month, we will discuss how to select an appropriate credit card and the factors that influence this decision.