Credit Cards & Payday Loans

- Payday Loans:

❖ What is a Payday Loan?
A Payday loan is a small loan, also known as a "cash advance." These loans typically become due in 14 days - your next payday. When taking out a payday loan, lenders require a check for the full balance of the loan (including interest and fees) that may be cashed when the loan is due.

Each state places different regulations and limitations on Payday lenders. The following information will focus on Washington's regulations. In addition, there is federal law that mandates certain consumer disclosures in writing.

❖ Payday Loan Regulations & Limitations:
In Washington State, payday loans are limited to a maximum of $700 or 30% of your gross monthly income, whichever is less. You are also limited to 8 payday loans in a 12-month period. If you cannot repay the balance of the payday loan when it comes due, installment plans are available. In order to take advantage of the installment plan option, you must notify the payday lender on or before the loan becomes due. It is important to note that if you currently have an installment plan, you may not take out another payday loan.

Payday lenders are prohibited from harassing or intimidating customers in order to collect on the loan. The maximum loan term is 45 days and the maximum fee for payday loans is 15% on the first $500 and 10% on amounts over $500.

Payday lenders, including internet payday lenders, must be licensed by Washington's Department of Financial Institutions (DFI). The DFI is the agency in charge of regulating payday lenders operating in Washington. You can and should verify a payday lender's license with the DFI before doing business with a payday lender.

- 1-877-RING-DFI
- https://fortress.wa.gov/dfi/licenselu/dfi/licenseLU/LicenseLLU.aspx

Federal law that pertains to payday loans and credit cards is the Truth in Lending Act (TILA). Under this Act, lenders must disclose to consumers any finance charges and the Annual Percentage Rate (APR) in writing.

❖ Payday loan: Common Mistakes
Payday loans are a convenient, but costly way to get cash quick for unexpected expenses. One mistake that should be avoided is the temptation to take out a payday loan for more than you need and can afford to pay back at the end of the term of the loan. Taking out more than you need or more than you can pay back can lead to a domino affect, such as taking out more loans and defaulting on your payday loan. Ultimately, you should try to avoid taking out these costly short-

term loans by seeking out alternative ways to borrow money, such from friends or family members.

- ❖ Payday loans & Credit Cards – Terms and definitions:
  In order to understand how credit cards and payday loans work, it is important that you know some key terms, their definitions, and some examples to further explain their meaning.
- Principal: original amount borrowed or value of the loan excluding any associated interest and fees

- Interest Rate: percentage of the principal charged by a lender to borrow a sum of money. In other words, it is the cost of borrowing/using the lender's money.

- Simple (Basic) Interest: the most basic of interest calculations. It is the interest accrued on the original principal only. However, consumers should keep in mind that APR is really what they should look for when considering a loan. Simple Interest = principal x interest rate x # of periods.

- Most credit cards calculate interest rates using an Average Daily Balance (ADB) calculation. ADB is calculated by taking the sum of your account balance each day, divided by the number of days in the billing cycle. Here's how the ADB is calculated:
    - Balance x APR% x # of days in billing cycle/365 = amount of interest applied to the credit card balance

- Annual Percentage Rate (APR) is the interest rate that is calculated on an annual (yearly) basis. The APR is the yearly cost of a loan including credit cards, which are loans. Remember, the Truth in Lending Act requires lenders to provided consumers with APR.
    - Here's an example of how APR actually works with a credit card. If your credit card has an APR of 14%, the monthly interest rate is: 14% ÷ 12 months = 1.167% *Calculated based on simple interest, not including compound interest.

    - Here's an example of how APR works with payday loans. Let's say you took out a payday loan for $500 for a 14-day term with a 15% fee ($75), which is an APR of 391%. When the loan comes due, you would owe $575. Let's take a look at how this is actually calculated. In this scenario, 15% interest (this is the fee for the loan) is charged during the 14 day loan term. 15% divided by 14 days = 1.0714% interest per day. The APR is then calculated by multiplying 1.0714% interest per day times 365 days in a year, which equals 391% APR. The total owed would then be $575.

- Renewals or Rollovers are a way to extend the date the loan is due for an additional fee. For example, if the loan is due 14 days from the time you took out the payday loan, but after 14 days you are unable to pay back the balance due, you may rollover the balance plus an additional fee. However, rollovers are prohibited in several states. Washington does not allow rollovers.

- Credit Cards
- Compound Interest: What is it and how does it work?

<u>What is it?</u>

Compound Interest can be a confusing concept, but simply put, it is the interest earned on the previous term's principal plus interest. First, you have the interest earned on the principal or unpaid balance for a term. Then, interest plus the principal is then included in the interest calculation for subsequent terms. This can best be explained though a simple example. Let's say you borrow $100 with an annual compound interest rate of 10%. What would you owe after 2 years including interest?

1st year: $100 x 10% = $10 interest
2nd year: $110 (balance + 1st year interest) x 10% = $11
Total owed: $121 ($100 + $10 + $11)

In contrast, if you borrowed the same amount for the same number of years with only simple interest you would owe only $120.

$100 x 10% = $10 interest
$10 interest x 2 years = $20 total interest
Total owed: $120 ($100 + $10 + $10)

In this example, the difference may seem inconsequential, but imagine a larger principal with a higher interest rate that is compounded quarterly. The effect of compound interest can balloon the total you owe quite quickly!
Note: compound interest is not all bad. It can really work in your favor when you have a savings account or investment over a long period of time.

<u>How it works:</u>

Have you ever looked at the back of your credit card statement? This is where you will typically find explanations for how the interest on your balance is calculated, fees for late payments, and other information.

Most credit cards calculate interest rates using an Average Daily Balance (ADB) calculation. ADB is calculated by taking the sum of your account balance each day, divided by the number of days in the billing cycle. Credit cards are a prime example of where you will see compound interest at work. Because your interest charges are calculated using ADB and your balance likely includes interest from the previous billing cycle, the interest is compounding. In other words, you are being charged interest on the interest you have already accrued. For example, you have a store credit card with an APR of 18%, a balance before the current billing cycle's interest of $300, and a 31 day billing cycle. The ADB Interest Calculation: $300 x .18 x 31/365 = $4.59 interest (new balance owed: $304.59).

- Late Fees & Penalties:
  Credit card companies love late fees and penalties. For credit cards, one of the harshest penalties for late payments is seeing a dramatic increase in the APR on your credit card and also a fee for the late payment. Late fees are typically $35 per occurrence. The end result is that you are penalized twice! You will now pay more for the money you have borrowed and you are charged a late fee, which will also earn interest!

- High Cost of Minimum Payments:
  Paying only the minimum payments will increase both the number of payments made and the total interest owed on the debt. Making only minimum payments will also not likely reduce the amount you owe. In fact, paying only the minimum may result in higher balances each month due to high interest rates and small monthly payments. Making minimum payments will not necessarily affect your credit score, but it is important to keep in mind that holding large amounts of debt can lower your credit score.

  Minimum Payment Example:
  If you have taken more than a cursory look at your credit card statement, you may have noticed a "Minimum Payment Warning." This warning shows you how long it will take to pay off your debt with only a minimum payment. So let's take a look at a credit card with a sizable balance and how a minimum payment versus a larger payment would affect both how much you will pay and how long it will take to pay off that balance. You have a credit card with a $14,700 balance, an APR of 15.24%, and a minimum payment of $318. If you pay only the minimum, it will take you 24 years to pay off and you will pay $32,274. In contrast, if you pay more than the minimum pay, such as $512, it will take you only 3 years to pay off and you will pay $18,430.

- Common Mistakes: Credit Cards
  Having too many credit cards can have several detrimental affects, especially if the balances and interest rates are high. Too many credit cards can affect your credit score if your debt-to-credit ratio is too high because you are carrying too much debt. In addition, overuse and carrying a balance on several credit cards can stress you and your budget, which may lead to late payments, fees, and higher interest rates.

  Another common mistake is not reading the fine print. Specifically, not reading the credit card application before you apply and not reading the back of your current credit card's statement. Reading the "fine print" helps you to understand your current interest rate, whether it is introductory, when the interest rate can or will change, and the fees and penalties associated with the card's use.

  Credit card advertisements emphasize the positive. When you get a mailer or watch a TV ad, you usually only hear or see the great introductory interest rates in big letters with much fan fair. You need to look much closer to see that after a few months the rates jump and depending on your current credit situation, that rate jump can be dramatic. So, the mistake here is not necessarily applying for a card with a low introductory rate, but it is with not being aware of when the rate changes and what the new interest rate will be.

As previously stated, paying only the minimum payment can be a costly mistake. Minimum payments result in more payments, interest accruing, and ultimately a much greater amount paid for the money borrowed.

Late payments are not something anybody wants to do, but it does happen. Sometimes this is due to forgetfulness, most commonly it is due to payday coming after payment is due, and it may also be due to some unforeseen expense that affected your budget. To avoid this common mistake, it is important to make a budget where your payments coincide with your paychecks. In addition, you can work with your credit card companies to adjust the time of the month in which payments are due. In other words, you need to budget and schedule your payments so that you can avoid late payments.

Looking at credit card statements can sometimes feel a little overwhelming, but avoiding looking at them can be a costly mistake. Checking statements is important for monitoring your credit limit, any changes in the interest rate, incorrect or fraudulent charges, and changes in your balance. In addition, reviewing and understanding your credit card statement can help you to adjust your payments in such a way as to decrease your debt and payoff the balance quicker, which will save you money in the long run.

Finally, one of the most common mistakes is making unnecessary or impulse charges on your credit card. Small purchases add up to big balances and lots of interest. So, when making a purchase you need to ask yourself, “Do I need this item?” and “Can I pay for this in cash rather than charging it?”

❖ Best Practices: Credit Cards & Payday Loans
The following best practices and suggestions can help you avoid the common mistakes associated with credit cards and payday loans.
Establish and routinely contribute to a savings account or some other “rainy day”/emergency fund. Even if you can only save a small amount each month, it adds up and earns interest. In addition, having a secondary source of cash can help you avoid late payments, penalties, and fees.

Make sure to routinely monitor your statements for any changes, errors, credit limit, and balance. Monitoring your statement will help you to budget your monthly payments to pay off the balance sooner, catch error or fraud, and to try to adjust your interest rate or transfer your balance to another card.

Shop around - there are a plethora of choices when it comes to credit card offers and payday loans. Make sure to shop around for the best rates, lowest fees, and best perks.

If your credit card's interest rate is too high, you should call your credit card company to see if there is any way to reduce the rate. Your standing with the company and length of time that you have been a customer will often work in your favor for an adjustment. If you cannot lower your interest rates, consider transferring some or all of the balance of the higher interest rate cards to those that have a lower rate. This will save you money in the form of accrued interest and also help you to focus your financial resources on fewer cards.

As previously discussed, making more than the minimum payment will save you money and help you to reduce your debt-to-credit ratio.

Make a budget that includes contributions to an emergency fund or savings account and overestimates your expenses. This will provide you with a cushion and an alternative to payday loans or using your credit cards.

Only charge or borrow what you can pay off each month or at the end of the term. This practice allows you to build a good credit history and avoid added cost due to interest charges.