Interest Charges

Credit Learning Center

A quick tutorial on how interest is determinded so you can work towards lowering your payments.

Previous

Next

Additional Credit Topics

Interest Charges by Steven Anderson

Interest Charges

Everyone loves the freedom and flexibility they get with credit cards, but everyone hates the unpredictable interest rates they get with those cards. Well, truth be told, those interest rates aren't that unpredictable. Credit Card companies use a variety of methods to calculate that number. Sadly, many people make the mistake of not understanding how their interest rate is calculated. So we are going to talk about the different calculation methods and how they work.

$$\overline{x} \pm z \frac{s}{\sqrt{n}}$$

If you intend to keep a balance on your credit card and pay over time it is very important to know how those interest rates are calculated. Let's talk about the different methods that they use to figure everything out.

First we'll start with the Adjusted Balance. This one is simple, actually. First you deduct all of your payments from the previous monthly balance. This does not factor in new charges. Then the interest rate is determined by referencing a common, accepted rate, usually the Prime rate, 1, 3 or 6 month Treasury bill rate or the Federal Reserve discount rate and then adding a percentage to these rates. One other point to consider for this is that this is the most favorable way to calculate interest. This method provides for one of the lowest interest rates.

However, it isn't the only way. We also have the Average Daily Balance. This is the most common method of calculating interest. The issuer simply adds together what you owe each day and divides it by the number of days in the billing cycle. Since this is the most common method we are going to give an example.

Say you owe a constant $100 dollars at the end of each day. Your figure will look like $100x31/31 days = $100 daily balance. That one was easy. Say you have a balance of $400 for the first 14 days and then a balance of $1200 for the last 17 days it'll look like 400x14+1200x17/31 days = 838.71 average daily balance. Finally the issuer takes your daily balance, multiplies it by your APR and then divides by 12.

Things to keep in mind for this method are your time periods. Billing cycles rarely start or end with the months. And billing cycles are seldom a month long. Usually they start in the middle and end in the middle. Another thing to keep in mind is that you will pay more interest if you make a large purchase at the beginning of the billing cycle rather than at the end. However, you run the risk of a large payment hitting the beginning of your next billing cycle instead of the end of your current one.

Last we have the Two Cycle Average Daily Balance. This calculation is less common than the other two and uses an average of your last two billing cycles. This works similar to the Average Daily Balance except now you have two cycles to think about instead of one. Here's an example:

If a cardholder has an average balance for the months of December, January and February of $100, $1000 and $100 he will have an interest calculated of $550 for December, which is only 55% of the expectant interest. But in February the interest will be based upon $550 again which is 550% higher than expected.

Some things to consider for this method is that it is the most expensive way to calculate interest, however if your balance is paid in full each month this could this could work out well for the consumer. Even though it may help, many experts suggest avoiding credit cards with this type of interest.

So now you know how to calculate your interest, but if you are anything like me you would be more interested to know how to avoid interest all together. Most card issuers offer a grace period of 20 to 25 days, while a rare few offer up to 30 days. This grace period is the time you have to pay your bill in full before interest is calculated. Interest is only calculated when you carry a balance into the next billing cycle therefore if you pay the balance in full before the end of each billing cycle there is no balance to be carried over and interest is not charged. So when you get your credit card it might be a good idea to develop good and smart spending habits to save yourself some money in the long run.