

The cost of credit

Handout 6-3

How interest is calculated on a credit card

- The Visa interest rate is 20% annually
- The balance owing on this card is \$1000
- Monthly interest charges are the balance, multiplied by 20%, and divided by 12 months
 $\$1000 \times 0.20/12 = \16.67 interest per month
- If you pay the 2% minimum payment of \$20, you will only be paying \$3.33 toward the \$1000 balance. The rest will go to pay the interest
 $\$1000 + \$16.67 - \$20 = \996.67 remaining balance

Here is what happens if you make only the minimum 20% payment for three months:

	Payment	To interest	To principal	Balance
1st month	\$20.00	\$16.67	\$3.33	\$996.67
2nd month	\$19.93	\$16.61	\$3.32	\$993.35
3rd month	\$19.87	\$16.55	\$3.32	\$990.03

- If you only pay the minimum payment of 2% toward your debt each month, it will take you more than **9 years** to pay off the debt. This will **cost over \$1168** in interest and the item will cost a **total of \$2168.02**.

Note: If you paid **\$5.00 more** each month on this minimum payment, you would pay back the balance **3 years and 6 months** sooner and save **\$506.35** in interest.

How interest is calculated on a loan

- A \$1000 loan at 12% interest, to be paid over a two year period
- Equal monthly instalment payments would be \$47.07
- Each month, as the balance goes down, you pay less interest and therefore more towards the principal.
- The full payment schedule would include **24 payments**. The total interest cost would be **\$130.16**.

	Payment	To interest	To principal	Balance
1st month	\$47.09	\$10.00	\$37.09	\$962.91
2nd month	\$47.09	\$9.63	\$37.46	\$925.46
3rd month	\$47.09	\$9.25	\$37.84	\$887.62

The online calculators used to calculate these payments are included in the resources handout for this module.

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Handout 6-3 (continued)

Comparing the cost of credit

Payment method	Cost of item	Interest and fees	Total cost of item
Cash or debit	\$1000	0	\$1,000.00
Credit card – pay in full by due date	\$1000	0	\$1000.00
Credit card – make minimum payment only at 20% interest	\$1000	\$1,104.63 interest over 10 years	\$2,397.26
Buy Now, Pay in 1 Year – pay balance in full on time (no interest)	\$1000	\$50 set up fee	\$1,050.00
Buy Now, Pay in 1 Year – pay balance in full but one week late (28% interest from date of purchase)	\$1000	\$50 set up fee \$373.09 interest	\$1,429.09
Buy Now, Pay in 1 Year – begin to make \$100/month payments after due date	\$1000	\$50 set up fee \$1,202.69 in interest	\$2,252.69