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FLIP FEATURE

Credit Cards: Understanding Pitfalls

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By Prof. Yannick Roger Post

According to a WalletHub survey at the end of 2024, 85% of college students owned at least one credit card. Credit cards are certainly convenient, and they are a good way to help students build credit. In fact, having an established credit record can be especially helpful after graduation, as students seek to rent apartments or take out loans to buy a new vehicle. Not to mention that many employers now also check applicants' credit scores as part of their hiring process.

Credit cards, however, can be a double-edged sword for students. In this article, we will review the most common pitfalls of credit cards that you, as a student, should be aware of and steer clear of:

1. **Debt Accumulation:** a credit card essentially gives you the opportunity to spend money you do not have, which can lead to overspending and debt accumulation. Let's face it, it is easy to overspend in college. There are always birthdays and special occasions to celebrate, fun activities to participate in, dinner/lunch/coffee dates to go on, Spring Break trips, not to mention occasional car repairs and other unavoidable life expenses.

   FACT: Every time a credit card is swiped, you are borrowing money from the bank. Either short-term, if you pay off your credit card balance when you receive your statement, or long-term if you are unable to pay off your balance. If you are unable to pay your credit card balance in full, you are most likely living beyond your means, therefore accumulating debt.

2. **Paying only the minimum amount required by the bank on monthly statements:** paying only the minimum amount will keep you in good standing with your credit card company. In fact, it will make your credit card company very happy since it now can charge you interest on your unpaid credit card balances. Here is what you need to be aware of:
   - Most credit card companies charge high interest rates (18% to 25% annually). Contrast those rates with the interest rates banks pay customers on checking and savings balances (.07% average on checking accounts, and .49% to .51% on savings accounts).
   - When only the minimum amount is paid, the remaining credit card balance is automatically subject to those high interest rates.
   - Most credit cards calculate interest daily, not monthly. Because of that, the interest balance that was calculated yesterday becomes part of today's balance. So tomorrow, you are paying interest, not just on your original debt, but also on the interest that got added today. This is how compound interest works.
   - When only the minimum amount is paid, a large portion of your payment is used to pay the interest you owe the bank. You are therefore not paying much of your actual debt balance down. As a result, your debt balance remains high and continues to accrue interest, resulting in a debt cycle.

- You could end up paying hundreds or thousands of dollars more than the original amount you charged on your card.
- For example: if you owe $1,000 on a card that charges 25% interest and you pay only the minimum amount, say $25 a month, it will take you over 7 years to pay off your balance and will cost you $1,172 in interest. It will effectively take $2,172 for you to pay off your $1,000 credit card.
- Under the CARD Act, Credit card companies must now provide an estimate (printed on your monthly statement) of how many months it will take you to pay off your balance if you only make minimum payments.
- If you have credit card debt and are currently only paying the minimum amount, go to this website to figure out how long it will take you to pay off your balance https://www.bankrate.com/credit-cards/tools/credit-card-payoff-calculator/

FACT: if you are unable to pay your credit card balance at the end of the month, you are living beyond your means. Change your spending behavior, and make an aggressive plan to pay off your credit card debt.

3. **Incurring fees:** credit card companies love to charge fees, such as annual fees, late payment fees, missed payment fees, and over-the-limit fees.
   a. Annual fees are yearly charges the credit card user is paying for the privilege of holding the card. Not all credit cards charge an annual fee. If they do, it is usually because they offer premium rewards to the users. If you are currently paying an annual fee, make sure to understand the benefits associated with the card. Consider switching to a credit card with no annual fee.

   b. Late payment fees are imposed when a credit card user fails to make the minimum payment by the due date. Even one day is considered late. Credit card companies used to charge around $30 for a late payment. The Consumer Financial Protection Bureau (CFPB) ruled that late fees should be capped at $8 per offence in March 2024. Yet banks still collected $14 billion in late fees in the United States in 2024.

   If your payment is late, make sure to pay as soon as possible. If you pay under 30 days late, your late payment will not show up on your credit report.

   c. Missed Payment fees are imposed when a credit card user completely misses making a payment. A missed payment has much more severe consequences. If your payment is 30 days late, it will be reported to the Credit Bureaus. This will affect your credit score and your ability to access credit in the future. A late payment report remains on your credit report for 7 years.

   If your payment is 60 days late, many credit card companies will trigger a Penalty Interest Rate, often 29.99%, and will start calculating interest at this higher rate on your credit card balance and any new purchases you charge on your credit card.

   Note: you will eventually be able to earn your initial interest rate back. This will require you to make at least 6 consecutive on-time payments. The credit card company will then review your account activity and determine whether to return your account to the lower rate of interest. However, you may need to be proactive and call your credit card company to get this process started.

d. Over-the-limit fees are imposed if you make charges above your credit limit. When issuing a credit card, credit companies determine an acceptable credit limit, the maximum amount they are allowing you to borrow. Think of it as a spending cap. It is based on factors like your income, payment history, and overall financial situation.
   Credit card companies will simply decline any charge that exceeds your credit limit, unless you have opted-in to allow charges above your limit to be authorized. If you have, your credit card company has the right to charge you fees. The first over-the-limit fee is capped at $25. However, if you exceed your limit again within 6 months, the fee can increase to $35.

FACT: know what your credit limit is and keep track of your charges. It will save you the embarrassment of having your credit card declined. Consider OPTING OUT of allowing transactions that exceed your credit card limit.

e. Cash advance fees are charged if you use your credit card to withdraw cash from an ATM. While it may be convenient if you are strapped for cash, be aware that it is one of the most expensive ways to access money. Credit card companies usually charge between 3%-5% of the amount withdrawn, and interest starts accruing immediately. The rate of interest charged on your cash withdrawal is typically higher than your standard rate. In addition, you may also have to pay an ATM fee.
   For example, suppose you withdraw $500 using your credit card at an ATM. If your credit card company charges a 5% cash advance fee: 5% of $500 is $25. If your cash advance interest rate is 29.99% and you take 30 days to pay it off: $500 x 29.99% x 30 days/360 = $12.33 in interest. If the ATM you used charged you $3.50, this $500 cash advance came at a cost of $40.83.

FACT: avoid taking our cash advances on your credit card.

f. Return payment fees are imposed if a payment you initiated bounces due to insufficient funds. The typical range is $25-$40. In addition, this will trigger a late payment fee since the payment did not go through. One returned payment event could cost you $70 in fees: $35 for the returned payment plus $35 for the late payment.

Building credit while in college has many advantages. However, it is important for students to understand the pitfalls associated with credit cards. A little discipline during your college years will pay off and protect your credit score. Remember:

- Paying your credit card balance in full every month will eliminate expensive interest charges
- Treating your credit card like a debit card will limit overspending
- knowing and staying below your credit limit will save you from potential embarrassment and limit your interest charges
- Paying on time will keep you clear of most fees, potential penalty interest rates, and reporting to the credit bureau.