HOW DO CREDIT CARDS WORK?

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This series is provided in partnership with Financial Counselling Victoria and is around debt. We follow the journey of Young Carer Julie through understanding debt and putting her knowledge into practice. If you haven't read the first post 'Understanding debt' you should start there!

DREAMER DIARIES

In late March, a few months after Julie dropped her camera, she finally went to get it fixed. She was shocked to hear how much the repair would cost, but it seemed worth it because she'd need the camera for her short film.

Three weeks later, Julie received a text from her mobile phone provider that read: 'Your bill is now overdue'. It was a surprise, as she'd set up a direct debit for her bill so that she'd never forget to pay it. She logged on to her internet banking app to discover that her account was almost empty. Looking through her statement, she had the horrible realisation that she'd already burnt through a lot of the money she'd saved over the summer… She hadn't used some *of her savings to pay for the camera repair – she'd used* most *of her savings. The outstanding phone bill cast a shadow over her empty account – the docile debt she'd agreed to when she'd signed up for her phone now seemed more sinister. She felt the pressure of the creature's eyes watching her – it remained by her side, but no longer felt like a pet.*

After the shock of the discovery wore off, Julie was left with a heavy anxious feeling, which continued as the week wore on. She counted up her current expenses:

- *her phone bill, which was now three weeks overdue (this meant that a new phone bill was also looming)*
- *subscriptions to Netflix, Apple TV, Disney Plus and Spotify, all of which came out of her account monthly*
- *the small monthly amount she paid her parents for bills and rent*
- *$50 she owed her friend after she'd forgotten her wallet and phone on a trip to the movies*

It seemed like a lot when you laid it all out like that, and Julie's single shift at the café certainly couldn't cover it. But then again – the school holidays were only two weeks away, and Julie would pick up extra shifts – and then she only needed to get through another six months of scrimping before the school year would be over and she'd be able to work five days a week. Looking at it like this, it didn't seem necessary to cancel anything yet – it was just a tight few months, and then she'd be raking it in like she had last summer.

So instead, Julie decided that she just needed something to tide her over until the end of school holidays. She needed some way of paying her friend back and covering her phone bill. With that in mind, she searched 'credit card' online and clicked on the very first result.

WHY MIGHT YOU GET A CREDIT CARD?

Like Julie, sometimes you might encounter an emergency or an unexpected expense that must be paid immediately. If you don't have much of a buffer in your weekly budget, an unexpected expense can make it difficult to keep up with your day-to-day payments. In this situation, credit cards can provide people with a convenient solution.

A credit card allows us to spend money on items at shops or online by simply tapping the card, avoiding the need for cash. Credit cards can also be used to pay for phone bills, subscription services and utilities. When you pay for something using a credit card, you are borrowing those funds from the bank. As you pay this money back, you will also have to pay back the interest (we discussed interest in the last blog – click here to find out more). This means that purchasing something with a credit card costs more than buying the same item upfront.

For someone in Julie's situation, a credit card offers a solution of sorts – although there is the danger that when bills are paid by a credit card, the debt remains or grows (although it now must be paid back to a different lender).

Julie had clicked on the website of a bank, which offered credit cards with a variety of credit limits. To apply, Julie had to provide information about her income and expenses – Julie provided the payslips she received over the summer when she was working four days a week. She was given a credit card with a $1000 credit limit.

Julie didn't know it at the time, but her decision to get a credit card was to trigger two processes that would prove difficult to wind back. Firstly, once Julie received her card in the mail, her debt creature started to grow – where it had once been a satisfying knee-height, like a very large ginger cat, it was now inching upwards towards her hip. Its fur seemed denser, darker, and more matted. Sometimes Julie swore that it gave off a certain unpleasant smell. The second development was less obvious – Julie's control on her debt was starting to slip, even as she thought she'd found a way of paying her phone bill.

CREDIT CARD FEATURES:

For anyone thinking of getting a credit card, it's important to understand the key terms and features of this sort of arrangement. This will help you to budget and plan for the repayments you will need to make.

- **CREDIT LIMIT**
  A credit limit is the maximum amount a bank will lend you – in practical terms, it is the maximum amount of money you can spend

using a credit card. For Julie, the bank has agreed to a credit limit of $1000 at the agreed interest rate. If Julie exceeds $1000 of spending, her interest rate will increase, but her spending will not be limited until it reaches default level (this happens if Julie is unable to make her repayments). This means that it is risky to exceed your credit limit as you
will be required to pay more with each repayment.

- **INTEREST RATE**

  Interest is a payment the customer makes for the use of the money they have borrowed, and is usually a percentage of the total amount owed – this percentage is known as the **rate of interest**. Interest rates can go up and down, meaning that the total cost of interest can change over time (currently, interest rates are at 20% per annum).

- **DATE TO REPAY**

  Part repayments of the total money owed to the bank are due at regular intervals. Most often, this interval is every 30 days – included in each repayment is an amount of interest, which is determined as a percentage of the remaining balance. The bank will suggest a minimum repayment, although the customer may decide to pay more if they like. The longer that you take to pay your credit card bill, the more you will pay in interest – this means that, if you plan to make the minimum repayments each month, you will end up paying a lot more money than you would had you made the purchase upfront. The MoneySmart website has a useful calculator we can use to check our credit card debt. If you do not pay the minimum repayment by the due date, you will be charged a late fee.

- **HONEY MOON ARRANGEMENTS**

  Sometimes banks can entice new customers by offering very low interest for first few months – this is called a ‘honeymoon arrangement’. While it might seem like a good deal to get a credit card with this sort of arrangement, remember that the card will usually revert to high interest after the first few months.

WHAT CAN GO WRONG?

The total amount that a customer pays on their credit card bill is likely to fluctuate over time as interest rates change – this means it can be difficult to properly anticipate the total cost of something purchased with a credit card. In addition, the repayment conditions of credit card bills mean that people who can only pay a small amount at a time – or those who miss payments – will ultimately pay a lot more than those who can pay the debt off quickly.

Sometimes we might not be able to meet the agreed repayment schedule for several reasons: maybe we lose our job or our shifts get cut, or other expenses occur unexpectedly, or a friend borrows money for rent. When this happens, the debt will be pursued by the bank or their debt collector. In this situation, it is wise to talk to a financial counsellor, their service is free and not aligned with any bank or shop.

SHOULD I GET A CREDIT CARD?

If you are considering a credit card, it is worth asking yourself the following questions:

1. What kind of repayment schedule would I be able to afford?
2. Do I really need the expensive item I am thinking of buying? (See our last blog for more info on wants v. needs analysis).

3. What bank/credit card will suit my needs the best? You can shop around and compare features, including: interest rates, interest-free days, monthly fees and late payment fees. For more information, click here.

There are also some alternatives to credit cards, which we've listed below:

- When it is possible, you can save for large purchases instead of using a credit card. This requires setting some savings goals, which you can find more about here.
- You may also wish to create a budget and track your spending, so you get a clear idea of where your money is going (and how much you have available for bigger purchases). You can learn more here.
- You can use a debit card instead of credit card. A debit card links directly to your bank account and only lets you spend money that you have. You can use a debit card in the same way as a credit card, including for online purchases, bills and subscription services. To find out more, click here.

If you are over 18 and experiencing a financial problem, it may help to talk to a financial counsellor. Their assistance is free, confidential and independent. If you would like to talk to a financial counsellor, click here to access the Carer Pathway to financial counselling.