5-31-1973

Revolving Credit for Consumers

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COOPERATIVE EXTENSION SERVICE — United States Department of Agriculture Cooperating

Economics Newsletter

Economics Department • South Dakota State University • Brookings 57006 • (605) 688-4141

No. 21 May 31, 1973

REVOLVING CREDIT FOR CONSUMERS

Have you ever been told by a sales person of a merchandising concern that their financing charges are only 10 percent per year or .833 percent per month? On the surface that sounds reasonable because most banks charge a similar rate. The truth is, this supposedly 10 percent rate is actually larger because of the method used to compute it. Most large retail merchandisers use this method of computation which does not violate the federal truth-in-lending law but does mislead the uninformed person. This system is not being criticized since it has allowed many individuals to enjoy goods and services now but pay later; however, it amounts to charging interest on money that is not even borrowed. The following example shows how the system operates.

Assume you purchase $700 of merchandise at your favorite retail store (most large retail and mail order concerns use the system being discussed here). Given that you obtain credit (a not too difficult task), there will be no down payment and your monthly payments will be relatively low, say $25 per month. You pay .833 percent per month on the previous month's unpaid balance.

It is the use of the previous month's outstanding balance that causes the rub. Why? Because, if you pay the account off at a faster than required rate, the interest charge is greater than the advertised .833 percent per month. Let's say you purchased the $700 item(s) on March 15, 1973. On or about April 2 you will be billed $700 and informed your minimum payment is $25 which must be paid prior to April 20 to avoid late charges. Assume the following day you receive a $600 refund on your federal income tax and apply the entire amount toward the $700 account.

If you had paid the $700 in full prior to April 20 there would have been no finance charges and an interest free loan would have been enjoyed for about a month (from March 15 to April 20). On May 2 you will receive a statement for $100 (the original $700 minus the $600 payment) plus an interest expense of $5.83.

Why such a large amount of interest? Because the interest was calculated on the previous month's balance. You have paid $5.83 to borrow $100 for one month which is 5.83 percent per month or 70 percent per year. Granted, if the debtor pays the revolving credit off in the minimum payment, the rate is close to 10 percent per year (actually 10.4 percent in our case). This assumes of course that everything is paid on time.

Let us say you faithfully continue to make your $25 payments per month but make additional purchases to bring your overall balance to the $700 limit. The $25 payment would be allocated as follows: $19.17 to principal reduction and $5.83 for interest. Therefore, each month, $19.17 of new merchandise could be purchased without exceeding the $700 limit. This amounts to paying $69.96

for the privilege of buying $230 worth of new goods during the year or, looked at differently, you are paying $69.96 per year to borrow $700. This amounts to $1399.20 over a 20 year period. The above example is one of the more moderate ones because the yearly interest rate is 10 percent which is usually levied in South Dakota. Some residents of other states are not so fortunate. At 18 percent per year the above results would almost be doubled.

Sometimes you may be able to save by purchasing a seasonal item (an air conditioner for example) during the off season in order to take advantage of a sale price. In these cases you may be allowed to purchase in, say, January and not start making payments until a few months later. The logical question to ask would be: "Is a carrying charge assessed while no payments are being made?" Sometimes it is. If so, this negates the bargain you initially received; thus, be sure you know what the sales agreement says before you sign.

A revolving credit "optional" which is very popular now is credit life insurance. This is an insurance plan usually offered by the retailer which pays off the revolving credit account in case of death or disability of the breadwinner. The usual rate is $.15 per hundred per month. In the $700 revolving credit account above, this would amount to $1.05 per month or $12.60 per year.

However, the going rate for $1,000 of term life insurance for a 30 year old male is $9.48 per thousand per year; that is $.79 per month for $1,000 of insurance in case of death or disability. You are obtaining $300 more insurance for $.26 less per month; a saving of about 25 percent. A term rider can be conveniently added to your whole life policy or other insurance carried. The reader can draw his own conclusions.

Revolving credit can be and has been a boon to many consumers. However, many people considering the use of this method of financing purchases should be certain that the credit agreement is fully understood and the amounts going to principal, interest, life insurance, and other financing costs are known. These can sound very cheap but in fact be very expensive. Once the agreement is signed, the terms are usually set. The name of the revolving credit game is to look before you leap.

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