Behavioral and Personal Finance
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Module – 02
Personal Finance
Lecture – 37
Credit Cards as Source of Consumer Credit

Hi, there. Continuing with the previous discussion on Consumer Credit and different sources of loans and other credit sources for individuals and household, we have learnt about consumer credit in terms of borrowings from different financial institutions. There is another source of credit which is very popular these days among individuals and families known as credit cards.

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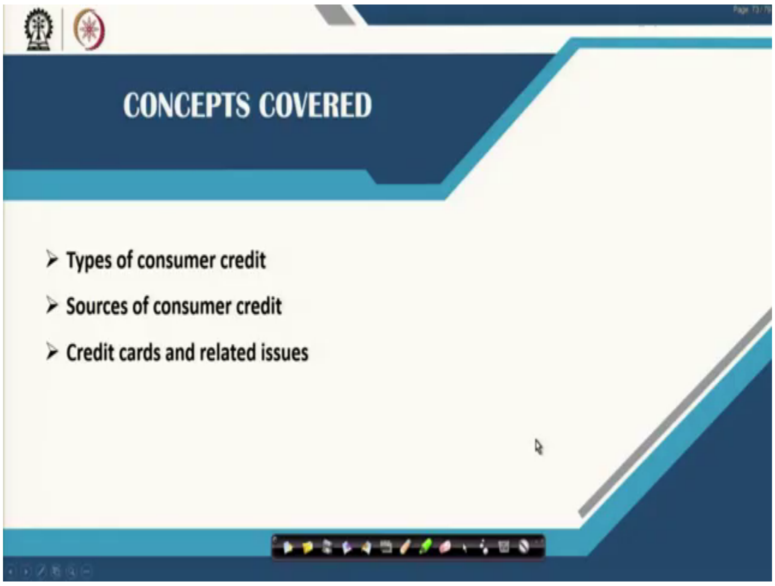

Basically, when we talk about Credit Card as Source of Consumer Credit, we have basically try to understand how credit cards can help individuals and families to plan their financial needs and spending pattern in a more structured way. But, at the same time it is also important to understand the advantages and disadvantages of having a credit card as a source of consumer credit.

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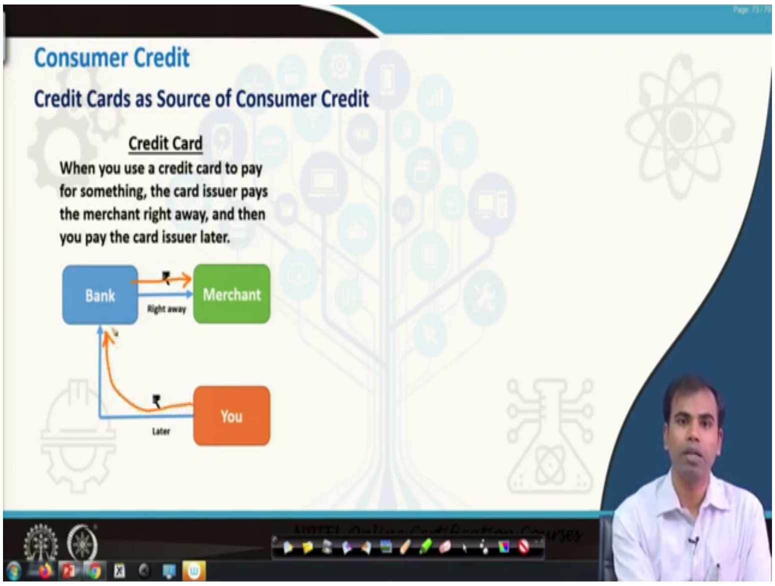

When we talk about consumer credit in terms of credit card as a source of the credit available for individuals, basically we mean that credit cards are sources of credit where when you use credit card for making a payment of a purchase of goods or services. The card issuer which is basically a financial institution or bank or a retailer in some cases pays the merchant immediately and you are charged that amount in your credit card bills and you pay that amount later on.

So, basically the flow of money that follows here is the amount of money that goes from bank or the issuer of the credit card towards merchants when you make a payment immediately, But the amount it charged to you on a later date and you pay that money to the bank or to the card issuer at a later date.

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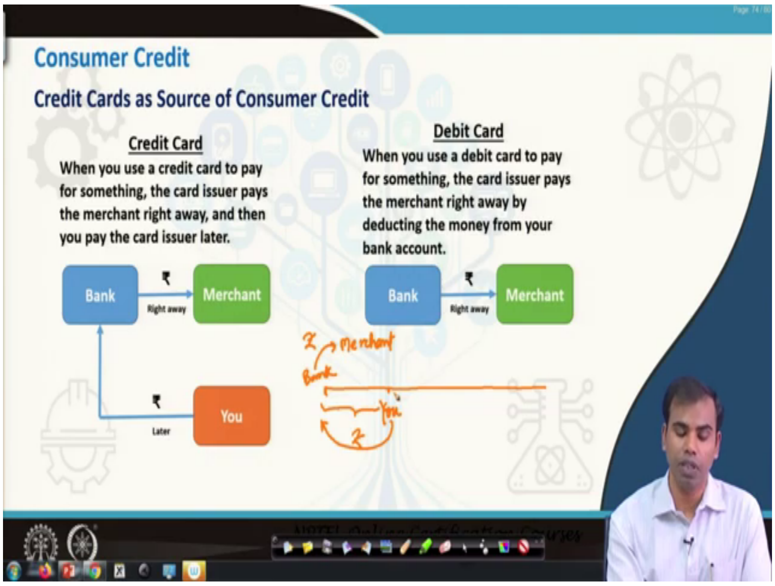

Which is slightly different because in case of debit card which is another way of making payment at different merchants are the when you use debit cards for purchasing something or making a purchase decision at any store or any other shopping outlet you basically make the payment right away and the bank charges you instantly. And that money goes from your bank accounts or savings account right away to the merchant.

So, with this basic difference we understand that one fundamental feature of current payment versus future payment that comes into the picture is the time value of money. So, if you try to connect this with the concept, if you make a purchase right now so, the amount of money that goes from bank to the merchant is right away which is the money has been going to the merchant immediately, but you pay the bank at a different time. So, you pay bank back at a later date.

So, here you save some amount of cause towards keeping that money with you for some time. The merchant gives you the product right away, but the amount of money that you pay to the merchant through your card although goes instantaneously, but the bank charges you that amount and you are liable to pay after certain number of days.

This feature makes the credit card uses very popular among people who have shopping pattern and who uses cards at every retail outlet or any other shopping avenues.

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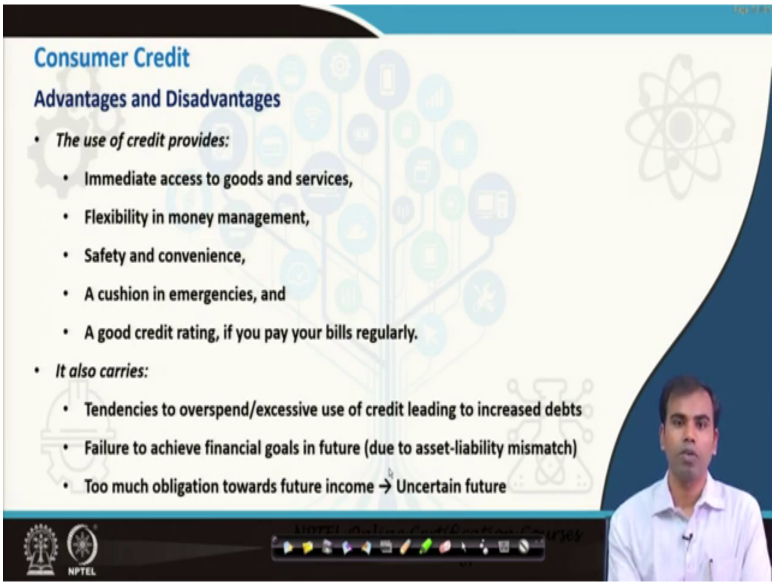

Basically the advantage and disadvantages associated with credit cards are as follows. Since you use credit card as a source of consumer credit, you have immediate access to goods and services. So, even if you do not have cash in your wallet you can buy or make that purchasing decision. It also offers you flexibility in terms of money management; because you know the amount of money that you have been spending on goes to which particular type of spending.

So, if you are spending more money on consumable goods or travel or hotel or food out items or groceries that can be traced by with the help of your credit card bills. So, it helps you in making your money management easier. It is safe and convenient because you do not have to carry lot of cash in your pocket all the time. You can use cards wherever possible. It also gives you a cushion in emergency because even if you do not have cash in your pocket, you can use credit card for cash withdrawal.

Certain credit card companies and other retailers offer you some amount of money as cash withdrawal facility for on credit cards. If you are a very regular consumer and a very well established consumer who is paying all the bills regularly your credit rating also improves thereby it helps you in getting such credit facilities in future at a easier way. Along with these advantages the issues that credit card uses offers or has are the tendencies to overspend or excessive use of credit card leading to increased debt.

So, if you have this habit of overspending or a reflexive decision making in terms of buying something which you do not really need you might end up having a lot of debt in terms of credit card over dues. If you try to manage your assets and liabilities in terms of future income and current spending, it might distort that particular asset liability matching process. Because you may spend more money in present time whereas, the future income is not so much and thereby your liability will be higher than the asset that you are going to hold or you are expecting to have.

If you do not pay the credit card bills regularly, it creates a very substantial amount of obligation towards future income and that is how it deviates you from the financial goals to be achieved in future.

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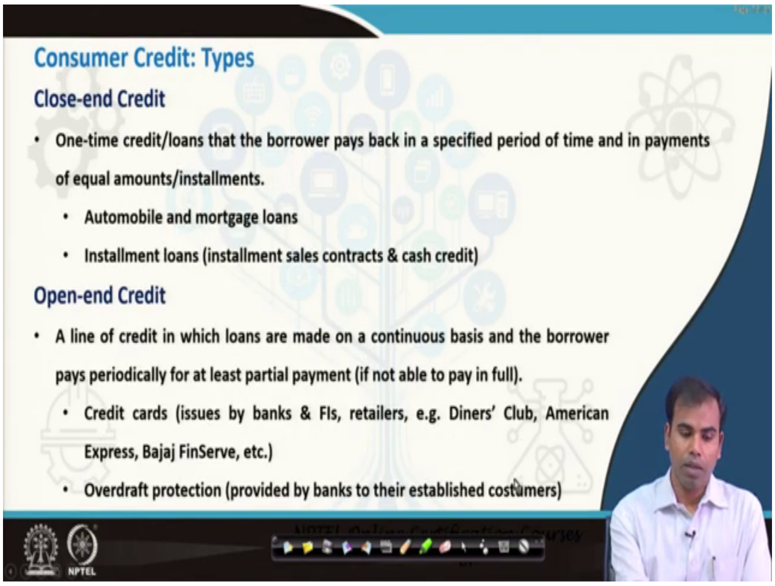

To understand the types of credit which are available for individuals and household, there are two types of credit – close end credit and open end credit. So, close end credits are basically credits which are one time credit available for individuals such as automobile and mortgage loans and installment loans where individuals or offered loans on credit in terms of one time the amount of money available for them.

Whereas, open end credit are card are basically cards which offer you to use that credit facility as and when required. So, for example, if you use credit card you can use open end credit feature, as in whenever you need to buy something or make any purchase decision you can use that credit card as a mode of payment. And, these credit cards are issued by different institutions or financial institutions, banking institutions and other retailers. Another similar feature of open end credit is overdraft protection, where banks allow you to withdraw money more than your savings account offers or your checking account offers.

These with these feature credit card has become extremely popular.

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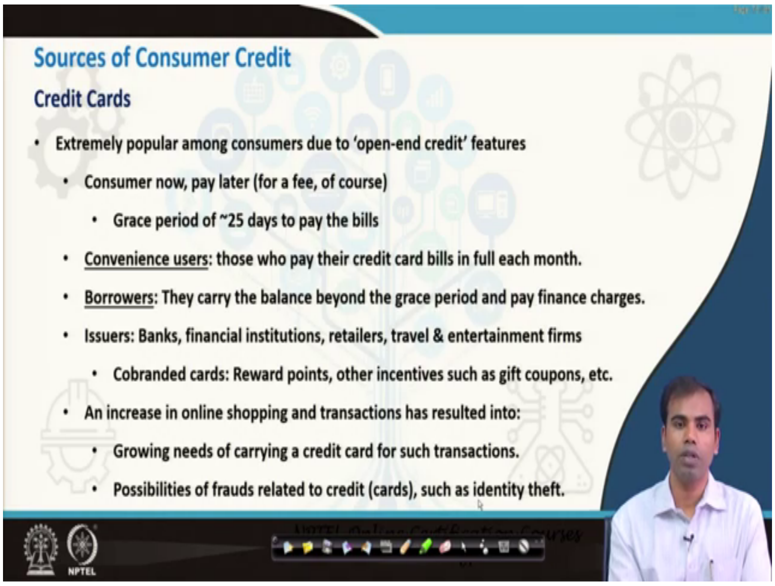

Now, the basic feature is you consume now and pay later. Typically most of the credit card companies or the issuing companies offer you a grace period of 25 days or so. Which means that the moment you make purchasing decision or purchases with the help of your credit card or your statement is generated or the bills are generated on your credit card transactions you receive 25 days of period for making the payment without any interest or financial charges.

If you fail to make the payment within that particular grace period, then credit card issuing companies start charging interest and financial charges. So, based on these features the users who are using credit cards are categorized into two types convenience users who use credit card as convenience shopping and they pay their bills regularly. And, the other category is borrowers who fail to make the payment within the time frame allowed for some reason and thereby they have over dues. And, that over deuces charged interest and other finance charges by the issuing bank or financial institution or other card issuing companies.

Well, with the increase in online shopping and other transactions made by individuals and households, the requirement for them to carry a credit card is increasing and this also leads to the possibilities of frauds related to credit cards. One of such popular frauds are very often reported frauds is identity theft wherein someone has taken the details of your credit card and made transactions representing or pretending to be the cardholder and thereby making the cardholder lose some amount of money.

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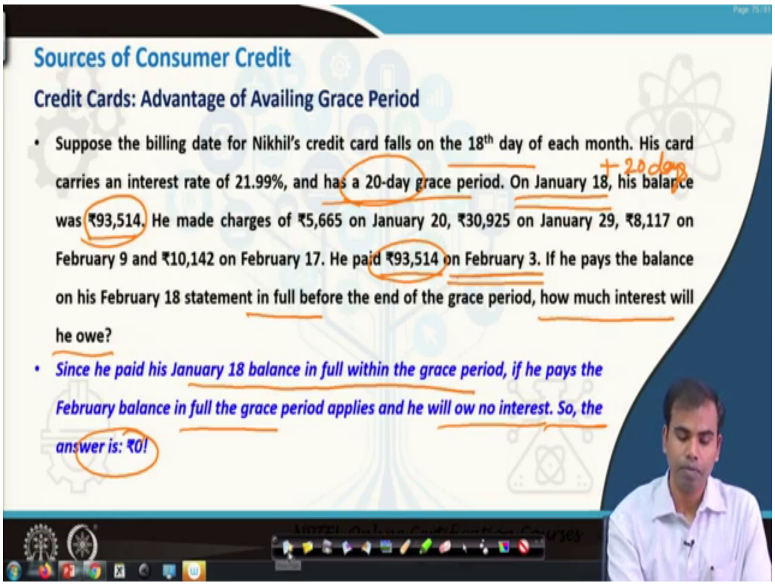

With these things the features associated with credit card issuance and the usage of credit card by individuals. We need to understand how these features actually translate into real money transactions or the losses or gains for the users as well as for the card issuing companies and other merchants.

So, one example here has been cited in terms of the grace period. We already discussed that after the statement is generated and bills are charged to the credit card users a grace period is allowed. So, if you look at this particular example, here it shows that suppose the billing date for an individual's credit card falls on 18th day of each month which means that at the end at the 18th day of each month the credit card issuing company generates the bills comprising of transactions in previous month.

His card carries an interest rate of 21.99 percent per annum and has 20 day of grace period. On January 18th, the balance was 93,514. He made some transactions of 5,665 on January 20th or another transaction of 30,925 on January 29th, yet another transaction of 8,117 on February 9th and finally, another transaction of 10,142 on February 17th.

Now, if you see here, the amount of money that was due on the previous date of bill generation which is January 18th because on 18th day every month the bill is generated the amount was due to the extent of 93,514. On February 3rd which is well within the grace period; so, on January eighth 18th plus 20 days of grace period the amount of 93,514 was paid.

If he pays the balance on his February 18 statement in full before the end of the grace period, whether he has to pay any interest on or not? Well, the explanation is since January 18th balance in full was paid within grace period he pays the February balance also in full within the grace period he owes knows no interest. So, the answer is 0.

So, the idea here is if your statement is generated on 18th January, you are given a 20 days grace period, the amount of money that was due to the credit card company was paid within that particular grace period then you pay no interest on the over dues amount.

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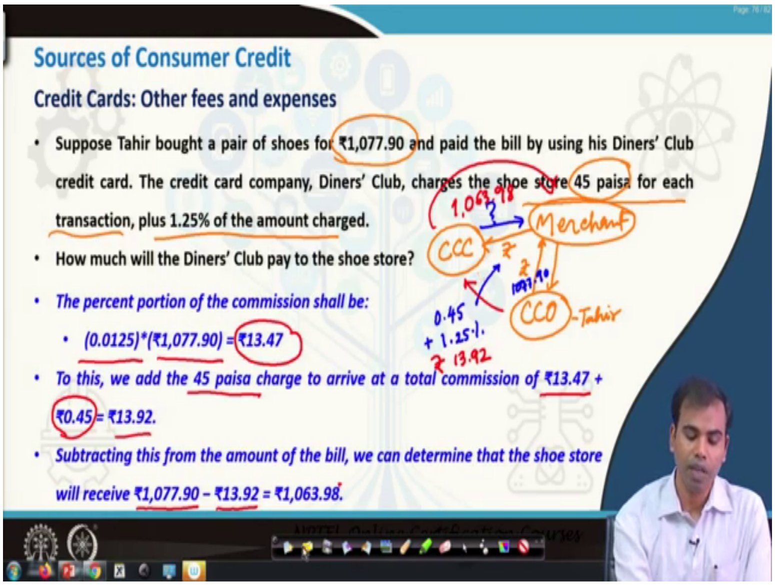

Similarly, another example of this nature or the amount of money that has been paid or that has been due to the credit card companies or other merchant is explained here. If you see this particular example, suppose a guy Tahir bought a pair of shoes for 1077 rupees 90 paisa and paid the bill through his credit card. The credit card company charges the shoe store 45 paisa for each transaction. So, basically this is the charge imposed by the credit card issuing company to the vendor or the merchant.

So, there are credit card company and then the merchant and then the credit card owner which is basically Tahir in this case. So, merchant has given the product right now and our credit he has made the transaction with the help of credit card. So, this amount goes to merchant immediately. So, credit card company charge some amount of money to merchant.

So, merchant has to pay certain amount of money, this is 45 paisa per transaction plus 1.25 percent of the amount charged.

Now, the question here is how much money the card issuing company will pay to the shoe store? So, if the price of shoe was 1077 rupee 90 paisa and the merchant has to pay 745 paisa of plus 1.25 percent of the amount charged to the card issuing company how much money will go to the merchant. So, the argument here is the amount of money that merchant has to pay is 45 paisa plus 1.25 percent of the bill charged. So, how much money should go towards this one this particular credit card company to the merchant? Here the amount is paid 1077 rupee 90 paisa.

Now, the calculation is as follows. The percent portion of the commission shall be 1.25 percent into the bill amount that were charged so, 13 rupee 47 paisa plus 45 paisa was charged to arrive at a the total commission; 13.47 plus 45 paisa which is basically 13.92. So, the credit card company will get 13.92 rupees basically 13 rupee 92 paisa.

So, the net amount that has gone to credit card company is the price that were charged to Tahir minus the commission or the amount that credit card company will receive from the merchant. So, 1063 rupees 98 paisa will go towards merchant as the price of the shoe. So, that is why sometimes you see that some companies charge certain higher fee or higher commission for using their credit card and in some cases that money might be recovered from the credit card user. In some other cases money is recovered from the merchant where the credit card is used.

These are some of the features that can be considered while using the credit card by individuals and household .

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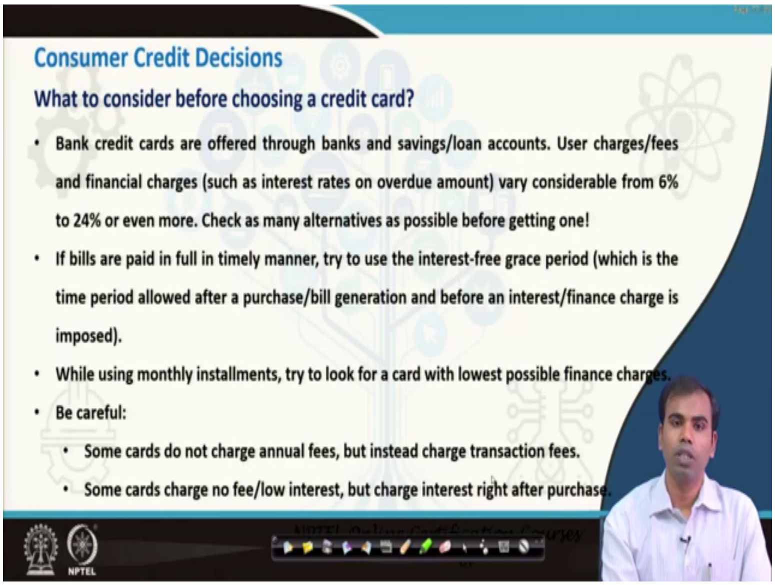

There are certain other factors that we need to consider before using credit card. For example, bank credit cards are offered through banks in terms of their customers savings and loan accounts. So, if you have maintained a savings or loan account with any bank they will like to offer you credit card and the user charges or other financial charges are very considerable in terms of a wide range of interest rate and financing charges are imposed.

So, it might go from 6 percent to 24 percent in India most of the cases. So, be considered these financing and interest charges well before you decide which car to go for. If bills are paid in full in a timely manner then you should better use the grace period because that grace period is interest free where you can retain the money with you instead of paying instantaneously. The period might typically go from 20 days to 25 days in most cases. So, you can hold that cash with yourself for 20 – 25 days and save some amount of money.

If you are using any monthly installment which is basically EMI sort of features associated with credit card then try to look for a card that has lowest possible finance charges because in that case the amount that is charged in terms of financed charges for the overdue amount will be low ah. We should always be careful that some cards do not charge annual fee, but they instead charge transaction costs recovered from the consumers.

Some cards whereas, charge no fee or low interest charges, but they charge right after the purchase. So, try to understand the difference in terms of cost and charges that are imposed on you for transaction as well as for the amount due.

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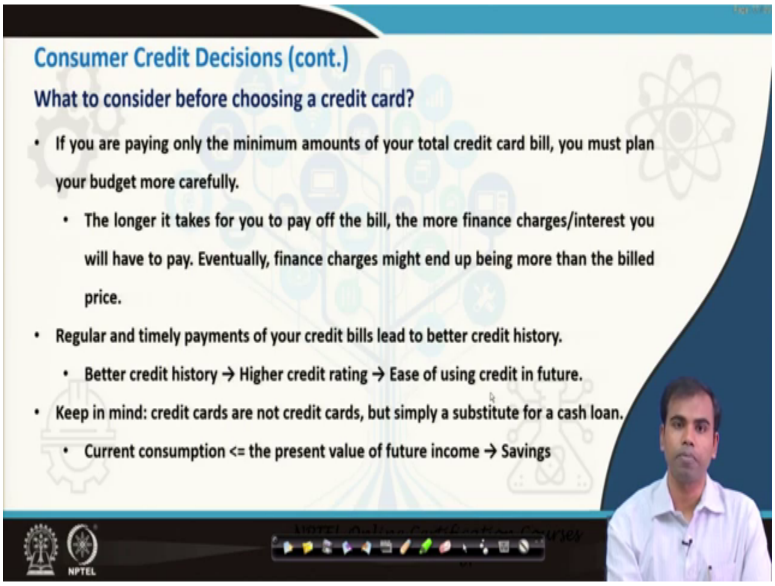

There are some other features that we need to consider before we make a decision with respect to opting for a particular credit card. If you are paying only the minimum amount that is mentioned in the credit card statement, try to understand that implication on your budget accordingly and you pay the amount that is due in full or if you are making in terms of the minimum amount to be paid you try to pay it off as soon as possible because the longer it takes for you to pay in the pay of the bill the more finance charges and interest cost you have to bear.

And, it might so happen that the total amount paid in terms of interest and finance charges might be higher than the total billed price. It is always best for any credit card user to have regular and timely payment of credit card bills because that will be interest free access to credit. It will also lead to a better credit history or credit rating that will improve over the period. And, if you have better credit rating you might have ease in accessing credit in future.

To conclude we should always keep in mind that credit cards are not credit cards, but simply or substitute of a cash loan. Essentially it is a future obligation for the current consumption and that is why it might affect our savings and other financial planning or decision making. For now, this is it.

Thank you very much.