Finance And Investing

4 Behaviors That Can Land You in a Credit Card Debt Trap

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Summary. While credit cards may seem scary at first glance, you can manage them in ways that serve your short and long-term goals. This starts by learning to recognize the early signs or behaviors that can push you into debt and finding ways to unlearn them. Here are four... more

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How comfortable are you talking about credit card debt?

If you have a strong negative reaction to that question, you're not alone. A recent Bankrate.com survey shows that 41% of Generation Z feel uncomfortable talking about their credit card debt (along with 38% of Millennials, 49% of Gen X, 53% of Boomers, and 59% of the Silent Generation).

While talking about money, in general, is hard, it's necessary to address the issue and stop your debt from piling up into an unmanageable number. The average credit card debt last year was a little more than $5,000. For Gen Z that number drops to around $2,000.

So, let's break the stigma starting now. The more you keep your money problems secret, the more anxiety (and problems) they will foster. The first step to overcoming your discomfort is to understand exactly what credit is and the impact it can have on your life in the longer term.

What is credit?

Most of your big, adult decisions — to buy a car, take out a student loan, or rent an apartment — are dependent on credit. Why? Because when you’re young, you may not always have the money you need to invest in and secure those assets. In such cases, credit comes in handy. Simply put, credit refers to your ability to borrow money. You borrow money to make a purchase now with the promise to pay back the borrowed sum over a period of time.

A credit card is one tool that aids this process. With a credit card, you are allowed to borrow money up to a certain amount (known as the credit limit) and are expected to pay it back every month by a fixed due date. When you do, it helps build your credit history (also known as a credit score or credit rating) — a three-digit number that represents how regular you are with your payments. The higher the number, the better your credit score as well as your access to the goods and services you want to access.

What happens if you fail to repay your credit card bills on time?

When you miss the due date for repayment, the bank starts charging you interest. For instance, if you borrowed $500 in a month and fail to pay the full amount back on time, the bank may charge you a small percentage of the $500 you borrowed. You will then be responsible for paying back the original amount plus whatever interest has been added on. When this happens over a long period of time, the interest grows and can add up to a significant amount of money, trapping you in a vicious cycle of underpaying the money you owe and owing even more each month as a result. This is how you land in a debt trap — and if you don’t address it immediately, it can damage your credit rating as well as your personal finances.

Being caught in a debt trap creates a host of problems. Unpaid credit card debt can reduce your credit scores, making it harder to obtain meaningful loans like mortgages when you need them. Even when you can get new loans, the cost of borrowing is likely to be much higher if you don't have a good credit score. This is because most loans charge a percentage of interest from the start, and the worse your score, the higher that interest will be.

Apart from that, debt can have adverse effects on your physical and mental health. Increasing debt naturally leads to stress, and can affect your sleep, depress your immune systems, and negatively impact your relationships and overall wellbeing.

How do you avoid the debt trap and manage your credit cards better?

While credit cards may seem scary at first glance, you can manage them in ways that serve your short and long-term goals. This starts by learning to recognize the early signs or behaviors that can push you into debt, and finding ways to unlearn them.

Here are some common practices to look out for.

Failure to control your expenses.

The most challenging part of managing your debt is figuring out how much you can spend each month without burning a hole in your pocket. Making purchases on your credit card can often give the illusion that you're getting things for free. It can be hard to recognize when you're just starting out, but learning to differentiate between your short and long-term needs (and wants) is critical to building healthy financial habits.

What you can do instead: Take a long, hard look at what you are doing to rack up that debt every month. What did you spend the most money on? Was it an essential expense? Could you have delayed that expense by a month or two?

Once you answer these questions, it will give you a realistic sense of what you could have avoided. But just doing this exercise won't be helpful if you don't build up a healthy budgeting habit. To create a successful budget, you need to understand how much you actually have and how much you spend each month. Ask yourself: What do you spend the most money on? What are the things you absolutely need to spend money on every month (rent, groceries, electricity, internet, etc.)? What are some expenses you can be more mindful of (entertainment, food, etc.)?

Once you create a list of expenses, you can start prioritizing them. See if there are things you can spend less on and evaluate how much money you're left with each month to repay your credit card purchases.

Just making the minimum payment is not enough.

A lot of us don't have a full picture of what minimum payments really mean. In financial parlance, minimum payment refers to the minimum amount that you're required to pay every month towards the debt. However, there's more to it.

The interest rate for credit cards is usually reported as an annual percentage interest or APR. This refers to the total cost of borrowing a loan, including the interest rate or any other processing fee. Though this rate is annual, companies calculate the interest on a monthly basis as well as keep track of the customer's daily balance (or the amount of debt that is currently held on their card).

Let's say you have an outstanding credit card debt of $1000 at the end of the month, your average daily balance is $1,500, and the credit card company sets its APR at 16%.

Now, the company will calculate your daily periodic rate or the interest you're required to pay at the end of each day. This is done by dividing the APR by 365 (the number of days in the year). In this case, it will be 0.16/365 = 0.00044. This is then multiplied by your average daily balance: 0.00044x $1,500 = 0.66. Finally, this number is multiplied by the number of days in your billing cycle (we'll say 30 days in a month): 0.66x 30 =$19.80.

That means, $19.80 is the extra monthly amount you're required to pay on top of $1000. So, if you made a minimum monthly payment of $25, your total repayable sum will look like this: $1,000 – $25 + $19.80 = $994.80. As you can see, this interest rate can slow your ability to pay off your debt. (And this doesn't include any additional late fees if you don't pay by your due date.)

With the average interest rate sitting at 16%, card balances can accelerate rapidly, making it that much harder to make the next payment.

What you can do instead: Before getting your credit card, read the credit card application form carefully. This will show how long it takes to pay off the card making only the minimum payment (naively assuming no other purchases). Generally, it can take a while to understand how you want to spend and repay your debt on a credit card.

If your credit card company has a high APR, it might be better to repay the entire debt as soon as possible rather than just relying on the minimum payment.

Falling for perks without looking at the fine print.

Too often, we look only at the benefits a card offers, such as frequent flyer miles or hotel perks. These perks come at a huge cost: very high interest rates. While these benefits may look tempting at first, it's important to analyze if they're truly worth it.

Further, these perks can also motivate some people to open multiple cards to get discounts. It can also be tempting to open multiple cards to split credit card debt to avoid hitting monthly limits.

What you can do instead: Look for good credit card terms and conditions that fit your spending habits. If you are someone who almost always pays off your credit card in full each month, a high APR might not be a big issue for you. In this case, the cashback and points may actually benefit you. But if you already struggle with minimum payments each month, it's important that you prioritize low interest rate cards over perks.

Be careful about opening multiple credit cards, even if it's going to get you a perk or low interest rate deal. That benefit may be limited, and if a balance remains when the promotional rate expires, you are right back where you started. Remember, just because your debt is spread out over multiple cards does not mean it's actually less. It might look that way, but you still have to pay all of it back over time.

Using credit cards as ATM cards or gift cards.

Many credit cards allow users to withdraw cash from ATMs or write checks against their credit limit. But these transactions come with a cash-advance fee, which can be as much as 3.5%. Basically, if you were to take out $500 from an ATM using your credit card, you might see an additional $17.50 on your credit card statement this month. Further, if you don't end up repaying the $517.50 by the due date, interest charges may apply.

What you can do instead: A good option is balance transfers, or the ability to transfer the debt of one credit card to another credit card. The idea is that you can transfer your debt from a card with a high interest rate to a card with a lower overall interest rate, reducing the amount you'll owe. This option can be useful when there is a zero-interest, low fee balance transfer, and you are confident that you can pay off the debt you are transferring before the promotional (or lower interest) rate on the new card expires.

Credit cards can be a great tool for young people to achieve their goals. To truly make the most of it, educate yourself on how each credit card works, understand the policies and try your best to make payments on time. Remember that building these habits will take patience and continuous effort. There are plenty of horror stories about debt, but there are also plenty of people who have gotten into debt and come out the other side. With discipline, education, and control, you can too. That's why it's key to begin learning about credit card debt as early as you can.

Editor's Note: The opinions expressed here are for general informational purposes only. It is important to do your own research and analysis before making any financial decisions. We recommend speaking to an independent advisor if you are unsure how to proceed.

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Kiara Taylor has more than 10 years of

experience in finance, ranging from fixed income to emerging markets. She enjoys writing on the impact of both micro and macro trends on global finance, and has contributed to Investopedia, The Balance, and Crunchbase.

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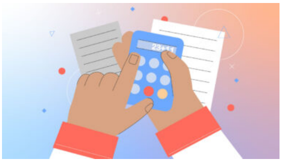
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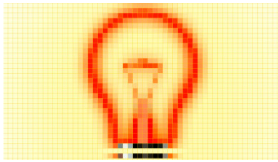
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