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# How Does Credit Card Interest Work?

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If you own a credit card – or if you've ever thought of applying for one – you have probably asked yourself: **how does credit card interest work**?
At first glance it seems relatively simple. But the details can be confusing. So we thought it would be useful to explain exactly how credit card interest works…

## How Credit Card Interest Is Calculated

Surprise! More likely than not, you don't realize exactly how the interest on your credit card is calculated.

In fact, credit card companies often rely on the fact that you will not understand how your interest is constantly compounding. Therefore, you need to protect yourself by understanding how compounding works in relation to credit card interest.

The term "compound interest" means that any interest charges are added to the principal (which is the amount you originally borrowed) so that your debt grows exponentially.

If you have a $100 debt and it accrues 10% interest every month, then the first month you will be charged ten dollars (100 x 0.10). With compound interest, that ten dollars is added to your original debt, so now you have $110 of debt. The second month you are again

charged 10% interest, which this time comes out to eleven dollars (110 x 0.10), so now you have $121 of debt.

You can see how it begins to add up quickly!

Compound interest has a big impact on how credit card interest works. Most people know their APR, which stands for Annual Percentage Rate. In general, your APR is supposed to equal the approximate percentage you will pay in interest over the course of a year. However, the actual amount you will pay is often slightly higher than the APR. *(See this explanation of the term "Average Daily Balance")*
These days, most credit cards compound interest on a **daily** basis, not monthly. For example, let's say you have a revolving balance of $10,000 on your credit card, and your daily interest rate is 0.041% (which is approximately equivalent to an APR of 15%). Multiply $10,000 by 0.00041 and you get $4.10, which means you'd pay $4.10 in interest on the first day. On the second day, your balance would be $10,004 and ten cents, and you'd pay interest on that total. Each day going forward, your interest would keep compounding until you had paid it off. Definitely not a pleasant thought!

It's wise to read the fine print on your credit card statement so that you know exactly how the interest is calculated on your card.

## When Are You Charged Interest?

Most credit cards give you a grace period of about one month to pay the balance listed on your credit card bill. If you choose to pay only the "minimum payment due" or if you pay any amount less than the total balance, you'll have to start paying interest on the remaining balance. *(To see how minimum payments can get you in trouble, read The Myth of Minimum Payments)*
Once that due date has passed, any leftover debt is considered a revolving debt and the credit card company will happily start charging interest on it. And your grace period of 30 days is also subject to being taken away if you don't pay the full balance. In that case you generally have to pay on time for two months in a row (and pay off the entire balance both times) to get back your grace period!

It's also worth noting that some credit card agreements allow the company to charge you interest on purchases you have partly paid off. For example, if you used a credit card to buy a new refrigerator for $500 and paid $400 off within the first month, you might still be charged interest on the entire $500 balance until you pay it off in full.

# Factors That Affect Your Credit Card Interest Rate

Of course, understanding how your interest accrues is only half the battle. You also need to understand how your interest rate is determined in the first place and how it can change.

When you apply for a credit card, there are three main factors that affect your initial interest rate:

1. The "prime rate"
2. Your credit score
3. Promotional offers

Let's take these one at a time:

**1. The "prime interest rate"**
You might wonder, "what the heck is a prime rate?" Good question. The prime rate is a kind of baseline interest rate that fluctuates over time based on certain economic variables. It's tied directly to the federal funds rate, which is the rate banks pay for short-term borrowing from the Federal Reserve. The prime rate is always 3 percentage points higher than the federal funds rate.
At the moment, the federal funds rate stands at an all-time low of 0.25%, and the prime rate is at 3.25%. When you sign a credit card agreement, you commit to pay the interest rate that is set by the credit card company, and that can change along with the prime rate: if your current rate is 15% but then next month the prime rate is raised from 3.25% to 6.25%, your interest rate would also likely increase by 3 percentage points.

**2. Your credit score**
Different people can be eligible for different interest rates. When you apply for a credit card, the credit card company checks your credit score to see if you are a good credit risk, and if your score is good, you'll be eligible for the best (lowest) interest rates. However, if your credit score is bad or average, you probably won't qualify for those rates.
**3. Credit Card Promotional offers**
A third factor that can complicate things even more is the fact that credit card companies love to create special promotional offers that tempt you with ridiculously low interest rates – for an introductory period of usually 6 to 12 months. These are especially common for balance transfer offers, which often give you an introductory 0% interest rate for at least 6 months after which you pay a higher interest rate. If you can use one of these offers in order to pay off your existing balance during the introductory period, this may be a

good deal for you. But if you fail to do so, the credit card company will usually charge you the higher interest rate retroactively on your entire balance.
That brings us to the fourth factor that affects your interest rate: your payment behavior. Unlike the three factors above, this one only affects your interest rate after you have signed the credit card agreement.

**4. Your credit card payment behavior**
If you do not pay your credit bills on time, your credit card company can (and usually will) increase your interest rate. The amount that it gets increased depends on the individual situation, but it can be quite a lot. (If you're in this situation, make a plan to get out of debt as fast as possible – ReadyForZero can help)
Believe it or not, late payments on credit cards and loans can cause your interest rates to go up on *all your credit cards*. If you have several credit cards, a missed payment on one of them could affect the rates on all your other cards as well.
The bottom line is you must be informed about how all of these factors work together to determine your interest rate. Read your credit card statement carefully and make sure you know how the interest calculation works for your card. *(See our article, How to Understand Your Credit Card Statement)*
We hope that the information above has helped to answer the question, "How does credit card interest work?" If you have more questions, just let us know!

*This article is part of our Credit Card Debt Resource Center. If you're looking for additional information about credit card debt, be sure to pay a visit!*