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Weigh before you pay: Debit or credit?

By Jayne O'Donnell

Among the debates that tend to vex shoppers — paper bags vs. plastic, plasma TVs vs. LCD — there's one standby: Credit or debit?

The decision isn't a trivial one. When you shop, how you pay for your purchase can determine how much protection you'll have should the merchandise prove defective, how quickly you'll get your money back and whether you'll be digging yourself out of debt years later.

Yet there's no one right answer for everyone. If you have the discipline to pay off your purchases on time each month, consider using your credit card, because you generally get more protection against faulty merchandise and fraud.

If, on the other hand, you tend to buy now and pay months later, you should stick to debit cards, cash or checks, because the money will come straight out of your bank account, sparing you interest charges. Just recognize that, even with debit cards, you could fall into debt if you're not careful. That's because banks are making it easier for you to overdraw and then charging you stiff fees for doing so.

There's also the risk that fraudsters will steal your debit card. Typically, if debit card fraud occurs, you'll have less protection than with credit cards. That's why some consumer advocates suggest you use debit cards sparingly — if at all.

"For a long time, people were saying, 'Use debit instead of credit,'" if you're debt-prone, says Ed Mierzwinski of the U.S. Public Interest Research Group. "But that thinking is shifting."

Still, both credit and debit have become ever-more-popular payment options. In 2006, for the first time, consumers paid for more purchases with debit and credit cards combined than with checks. Debit card use is growing especially fast; debit cards have surpassed credit cards as the most popular electronic payment, according to the Federal Reserve.

Before you pull out a debit or credit card, here's what you need to know:

Purchase protection and fraud

If whatever you buy proves defective, credit cards allow you to dispute the charges. Some debit cards do, too. But with debit cards, the benefits will vary by issuer, and sometimes depend on whether you signed for the purchase or instead entered a PIN.

With a signature debit card transaction, "There are very defined rules about how defective merchandise would get handled, and you have rights you don't have with PIN," says Edward Kadletz, Wells Fargo's head of debit cards.

Meanwhile, if fraudsters strike, you often have stronger protection with credit cards than with debit cards. With credit cards, under federal law, you're liable for no more than $50 if fraud occurs, though most issuers don't hold you liable for even that much. With debit cards, your maximum exposure is $50 if you report it within 48 hours. Report it after 2 days, and you could be liable for up to $500. Take longer than 60 days, and you could be responsible for the entire dollar amount of fraud.

Banks often provide more protection on debit card transactions than required by law. Yet there are always exceptions to banks' policies, says Travis Plunkett of the Consumer Federation of America, and those policies could change at any time.

Major banks, including Bank of America, Citi, Wells Fargo and Chase, say that they'll credit consumers within a few days for fraud losses on debit cards, then investigate.

Higher card use

A growing number of consumers are using debit and credit cards, instead of cash and checks, to pay for their purchases.

	Checks[1]	Debit card	Credit card	ACH EBT[2]
2003	46%	19%	23%	12%
2006	**33%**	**27%**	**23%**	**17%**

1 – paid; 2 – automated clearinghouse and electronic benefits transfer
Source: Federal Reserve

At Wachovia, "if they've had other transactions where (there's been) fraud in the past, we will take that into consideration" in determining how quickly to credit the account for losses, says Chris Roberts, a senior vice president at the bank.

Security experts say that if you use a debit card, you should sign for the purchase rather than enter a PIN. Why? Because while banks may offer zero liability for fraud that occurs with signature-debit transactions, they're often unclear about whether they'll provide equal coverage on PIN-debit card purchases, says Avivah Litan, a senior analyst at Gartner. Also, Litan warns, "If a thief steals your PIN, they can go to an ATM" and empty out your account.

Rewards

To encourage the use of credit and debit cards, banks offer points that can be redeemed for an array of rewards, including airline tickets, electronics and cash.

Credit cards usually offer more lavish rewards than debit cards do. And among debit cards, PIN and signature transactions aren't created equal. Signing for a purchase often earns you more points than entering your PIN does.

Citi's "ThankYou" rewards program generally offers up to five points for each dollar spent on a credit card. By contrast, it typically offers only one point for each $2 spent when you sign for a debit card purchase and one point for every $3 spent when you enter a PIN for a debit card sale. Other banks, including Chase and Wachovia, offer rewards on credit cards and signature debit transactions, but not on PIN-debit purchases.

Why the uneven rewards structure? Banks usually make more money from processing a credit card than a debit card transaction. And banks earn more when you sign for your debit card purchase than when you enter a PIN.

Convenience and cost

One obvious reason for the growing popularity of credit and debit cards is that plastic is less cumbersome to carry around than a checkbook or a wad of cash. Using credit or debit cards also provides you with a record of where you're spending money, which can help with budgeting.

Credit cards, of course, carry steep interest rates — especially for people with poor credit scores — and loads of fees. But if you have the discipline to pay off the card at the end of the month, you're essentially receiving an interest-free loan from the bank each month.

“The challenge” with a credit card, says Chris Allen, a director at Hitachi Consulting, is that “you have to make sure you have enough money to pay it back.”

Debit cards also impose steep fees. And as more shoppers use debit cards for small-dollar transactions such as coffee and milk, banks are making it easier for consumers to trigger these fees. A few years ago, most banks denied a debit card purchase if you had insufficient funds. Not anymore. Today, most banks will approve even the smallest debit card purchase — then hit you with a fee of $35 or more.

If you're going to use a debit card, sign up for low-cost overdraft protection. It will transfer money from your savings to your checking account if you overdraw. The fee for this service is often much less than the bank's fee if it automatically pays your overdraft.

There's also another option: “If you're really worried about (overdraft fees), then use cash,” says Leslie Parrish, a senior researcher at the Center for Responsible Lending.

Objectives

- Read the article “Weigh before you pay: Debit or credit?”
- Analyze the differences between credit and debit cards.
- Compare the benefits and drawbacks of debit and credit cards.
- Calculate the true cost of using a credit card as a loan.
- Investigate the potential cost of using a debit card for big or online purchases.

Preparation

Each student will need:

- A copy of the article “Weigh before you pay: Debit or credit?”
- A copy of the lesson.
- Access to the Internet or a copy of two different calculated tables from bankrate.com for Scenario 1.
- Access to the Internet for Scenario 2.

1. Read the article and answer discussion questions. (20 minutes)

Teacher: On the board, draw a grid that looks similar to the one below. Then, as students discuss their responses to the first four discussion questions, fill in the grid.

Credit		Debit	
Pros	Cons	Pros	Cons

- What are the benefits of using credit cards?
- What are the drawbacks of using credit cards?
- What are the benefits of using debit cards?
- What are the drawbacks of using debit cards?
- How can you protect yourself from overdraft fees on your checking account?
- What other ways are there to pay for purchases besides credit and debit cards?
- How do you usually pay for purchases?
- Most credit card companies do not issue credit cards to consumers under 18. The law says someone who is 18 can then enter into a legal and binding contract. If you were (or are) 18, would you use credit cards for purchases? Why or why not?

2. Credit or Debit? (25 minutes)

Directions: Teachers can allow students to pick one scenario or split the class in half. One half will be assigned the first scenario and the other half will be assigned the second scenario.

Scenario 1
You’re living on your own and fixing up your new apartment. You pick up some new rugs, an awesome home theater system and a comfortable futon. Before you know it, you have $3000 on your credit card which has a $3500 limit. The credit card company charges 15% interest a year (or 1.8% each month) on the whole amount.

1. For two months, you make the minimum monthly payments on the credit card. For the third payment, you pay off the entire bill. How much have you spent total for these items including purchase price ($3000) and interest? Note: Minimum payments are usually around 4% of the total bill. To calculate the first month, figure a $3000 starting balance and multiply it by 1.25% interest. Add the interest to the balance for the total owed. Multiply that total by 4% to figure your first month’s minimum payment. Then, subtract that payment from the new total to figure out your starting balance for the second month. You can use the back of this sheet for calculating.

2. If you make minimum payments for seven months, then pay off the rest of the bill in the eighth month, how much have you spent total for these items including purchase price and interest? Use the above formula to calculate.

3. Because of finances, you are only able to make the minimum payments each month. How many months will it take you to pay off the purchase price and interest? How much extra will you have spent in interest? Use the website below to calculate the time and extra cost.
http://www.bankrate.com/brm/calc/MinPayment.asp

4. Many credit card companies charge $39 if you go over your limit and $39 if you make your payment after 2 p.m. on the day it is due. If you are late even once while making payments, your interest rate could jump higher to what is called a “default APR.” In other words, by making a late payment, you defaulted or broke your agreement with the credit card company. Some default APRs are as high as 36%. That new higher interest rate is now charged on the whole remaining balance on your credit card. If you charge $3000 on your credit card and it has a 36% interest rate — even if you only keep the balance on the card one month — you will pay an extra $90. If you made late payments and still had $1500 left to pay off, how many months would it take to pay off the balance at 36% interest if you’re making minimum payments? Go to: http://www.bankrate.com/brm/calc/MinPayment.asp.

Scenario 2
You and a friend are going to Hawaii for one week in the sunshine with nothing to do but body surf and eat pineapple. On January 15, you use your First National Bank debit card to buy two online Aloha Airline tickets that will fly you roundtrip from Oakland, Calif. You write "vacation" across May 1-8 in your calendar. Ah, but there's a hiccup: On March 30, Aloha Airlines says it's ceasing any flights as of March 31. Hawaiian Airlines will only help out through April 3. You're now out $800 for the two tickets. The money came out of your bank account. You need that money to buy new tickets. Search the Internet for ideas you can use to get your money back in a timely fashion and still get to Hawaii in 32 days. Websites that can help you track down more information on how to get your $800 back are below.

www.fdic.gov/consumers/consumer/news/cnspr06/debitcard.html

http://us.bbb.org/WWWRoot/SitePage.aspx?site=113&id=1869d6a9-82aa-49a1-8419-40a8251fa916&art=312

http://us.bbb.org/WWWRoot/SitePage.aspx?site=113&id=1869d6a9-82aa-49a1-8419-40a8251fa916&art=484

www.ftc.gov

www.timesonline.co.uk/tol/travel/news/article4632359.ece

www.hasbrouck.org/articles/bankruptcy.html

Are there steps you can take to get your $800 back before your week of vacation? If so, what steps will you take? If not, what steps will you take next time when making a big purchase or online purchase?

3. Debrief and apply. (10 minutes)

Directions: Re-read both scenarios aloud. Then, as a class, discuss the questions below.

- For Scenario 1, did any of the information you calculated surprise you? If so, what?
- How much money would you end up spending if you only made minimum payments on the $3000 purchase? Did that surprise you?
- If you were going to make those purchases again (rugs, theater system, futon), what would you change?
- For Scenario 2, what did your investigation uncover? How did that make you feel? What will you do next time you make a big purchase or an online purchase?