

# What's Your Debt Really Costing You?

by Fabulously Broke, Saturday, November 13, 2010

provided by



The average American individual is 37 years old and carries \$5,100 in credit card debt, but what does that really mean and how does that affect them in the long term?

Believe it or not, this relatively small amount of \$5,100 in debt can add up to some big costs by the time retirement rolls around. To see the big picture, there are many factors to consider such as the interest cost of carrying the debt, lost savings and reduced purchasing power.

## The Interest Cost of Debt

The average interest rate on a credit card is 16.75%, and most credit card companies use an average compounding daily balance method, which means you will be paying interest on a daily basis. If our average American Joe doesn't pay off his \$5,100 in credit card debt, his minimum payment calculation is roughly as follows:

$\$5,100 \times (16.75\% / 365) = \$2.34$  in interest paid per day or \$70.20 per month with none of it being applied to his original \$5,100 balance.

Not too bad right? Now let's assume the credit card company says his minimum payments are \$76.50/month and Joe only pays the minimums each month. How long will it take for him to clear his debt?

The answer is over 300 months, or 25 years. The kicker is that he will end up paying almost \$20,000 in interest costs, on a credit balance of \$5,100. That's a 3.6 times what his original balance was, and Joe will be 25 years older before he's finally rid of his \$5,100 credit card debt.

Suddenly, \$76.50 seems like a lot of money to be paying each month, considering he'll be carrying it for the next 25 years. The final cost of his debt would be over \$23,500.

## The Cost of Lost Savings

Now if you factor in the cost of lost savings, the carrying cost of his debt takes a turn for the worse. Assuming he didn't have any credit card debt, but wanted to save a one-time lump sum until he retires, this is what the calculation would look like:

\$5,100 saved for 25 years, with no additional savings, calculated with a 5% real return on his money (including 3% for inflation) and compounded monthly would yield a grand total of \$17,755.

He would have made an additional \$12,655 above his \$5,100 savings just by letting his money sit there and grow. From a one-time contribution of \$5,100, it grew to over three times the initial amount after 25 years.

## 10 Things You Might Be Overpaying For

The reason why he earns less in total (\$12,655) than he'd have to pay out in credit card interest (\$18,401.60) is because of how frequently the balance compounds. The more frequently it compounds, the more money can be made because all those little fractions of a cent being added daily will accumulate over time, to a difference of \$5,746.60 versus monthly compounding.

### **Reduced Purchasing Power**

Now we know Joe had a choice to either pay an additional \$18,401.60 in interest towards his \$5,100 debt at the end of 25 years, or earn an additional \$12,655 on the same amount of money. But there's an additional cost to his living expenses seeing as he had to set aside \$76.50 each month to pay for carrying his \$5,100 credit card debt.

That amount of \$76.50 might not seem like a lot of money, but it pays for a surprising number of items:

- 15 cups of \$5 lattes each month, or one every other day
- Half of a grocery budget per month (assuming ~\$150 per month)
- 76 iTunes songs per month
- One night in a three-star hotel each month
- One month's worth of gas
- Dinner for two in a mid-priced restaurant including a 15% tip and taxes
- Seven new paperback books per month

And to think, if he didn't have that debt, Joe would be \$76.50/month richer, instead of having to scrimp on his budget to finance his debt.

### **The Bottom Line**

Carrying a little bit of debt at a low price of \$76.50 a month might not seem like a big line item in your budget. However, when you consider how much you will pay in interest costs over the life of the debt, the lost interest savings and all the extra things you could cover in your budget, the true cost of a little bit of debt becomes a lot more significant.