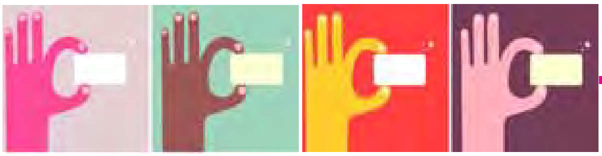

Paying with Plastic

A Consumer Action introduction to payment cards

Today, more consumers conduct a higher percentage of their transactions using "plastic" than ever before. That's because there are advantages—safety, for example—to using a payment card rather than cash in certain situations. But not all cards work the same way. Understanding the differences between credit, charge, debit, prepaid and gift cards will help you choose the best option for every transaction.

Payment card types

Though the various payment cards may look similar, there are important differences between them.

Credit cards. A credit card allows you to borrow money up to a pre-determined credit limit, through merchant transactions (purchases) and cash advances. You can pay your entire bill when it arrives and avoid paying finance charges, or you can choose to pay just a portion of the balance each month and pay interest on the rest. Visa, MasterCard and Discover are the three major credit card types.

Charge cards. Like credit cards, charge cards allow you to borrow money, but for a much shorter period—unless you participate in an extended payment program, you must pay the entire balance each month. Charge cards typically assess an annual fee, but may offer more attractive rewards and benefits for some users. American Express is the most widely used charge card.

Debit cards. Debit cards look like credit cards but are similar to checks in that the money spent with the card comes out of your checking account. Debit cards, which carry a Visa or MasterCard logo, can be used in two ways: 1) with a personal identification number (PIN), to withdraw cash from an ATM or to make purchases and request "cash back" at stores, and 2) with your signature, to pay for goods, meals, gas and services in person. They can also be used online or by phone, just like a credit card.

Prepaid cards. You can use a prepaid card in many of the same ways you use a credit or debit card—for purchases, to withdraw cash at an ATM and, depending on the card, to pay bills online or by phone. Before you can use the prepaid card, you must "load" it with funds. The money you spend is deducted and the card balance goes down. You can add more money (reload) the card as needed and keep using it over and over. Reloadable prepaid cards typically are branded with the Visa, MasterCard, Discover or American Express logo and can be used wherever cards of the same network are accepted.

Gift cards. Gift cards are a special form of prepaid card: The purchaser pays upfront to have a certain amount of money loaded onto the card for the recipient to spend. Once the balance on the card has been spent, it becomes useless because it can't be reloaded. Gift cards issued by retailers and chain restaurants can only be used at one of the company's own stores or establishments. Bank-issued gift cards—those with a payment network logo on the front (Visa, MasterCard, Discover or American Express)—can be used at any business that accepts cards with the same logo.

Card advantages and disadvantages

Each type of payment card has pros and cons—reasons to use the card, and reasons why another type of card, or cash, would be a better option. It's a good idea to know each option's advantages and disadvantages so that you can make smart choices about which card—or cards—to carry.

Credit cards are your only option if you want to finance your purchase over time. They also offer the strongest consumer protections in case of a dispute with a merchant, a billing error or an unauthorized charge. Many credit cards offer "cash back" or other types of rewards, plus benefits such as rental car insurance or extended warranty on purchases. Used responsibly, they can help you build a positive credit history.

Because credit cards allow you to carry a balance, they make it possible to spend more than you can afford and to accumulate debt. If you're late with a payment or two, you will not only incur late fees, you could see your interest rate skyrocket and stay there for months, and your credit may be damaged. Even if you're able to manage the minimum monthly payments, the ongoing finance charges on a large revolving balance are detrimental to your financial health.

Charge cards don't automatically allow you to carry a balance, which means you get the convenience and protection of a credit card without the risk of accumulating debt and having to pay finance charges. Charge cards have always been known for the exceptional rewards programs and benefits they offer, especially for travelers. And they affect your credit score in the same way as credit cards—an advantage if you manage the card responsibly.

Despite the popular belief that you must pay off your entire charge card balance each month, American Express, the company that issues the most widely used charge card, actually offers eligible cardholders the option to finance certain purchases if they enroll in its Extended Payment program, giving participating charge card customers as much opportunity as credit card users to get in over their heads. Also, some credit cards are giving charge cards competition in the area of cardholder rewards and benefits—sometimes with a lower, or no, annual fee. A charge card generally is not an option if you don't already have good credit.

Debit cards' biggest advantage may be that they truly don't let you carry a balance since the money for all your transactions comes directly out of your checking account. They also extend some valuable consumer protections—limited liability for fraudulent transactions, for example—though they aren't as strong as those offered by credit cards. For example, you don't have the same rights to withhold payment in the case of a dispute with a merchant. And, while stolen money will be restored to your account in most cases, you could lose access to at least some of your funds temporarily.

Another concern for debit card users who may not routinely keep a high balance or who are not diligent about tracking their transactions is the risk of overdrawing the account. A $3 latte could end up costing as much as $35 if you don't have enough in your checking account and you haven't opted in to allow debit card overdrafts. Even if you do have overdraft protection, there will most likely be a fee, though it would be much smaller than the cost of an overdraft. Some merchants could charge a small fee ($1 or less) for each debit card transaction.

Prepaid cards can be a solution for consumers who can't get or don't want a traditional credit card or checking account debit card, and for anyone who wants to avoid any risk of accumulating debt. While prepaid cards are not required by law to offer all the same protections that credit cards automatically provide, many issuers extend similar protections voluntarily.

Because you're not borrowing money, a prepaid card will not help you build a credit history, and it won't help you through an emergency if you don't have the needed amount of money already loaded onto the card. You may not be able to use your card to make airline, hotel and car rental reservations, though you should be able to pay the final bill with your card. But the biggest drawback to prepaid cards may be their many possible fees, including activation, ATM access, monthly "maintenance" and "reload" fees. As competition has increased, the fees on many prepaid cards have become much more reasonable and may be less than the cost of using a check-cashing service, particularly if you use direct deposit to "load" the card. But you still need to shop around and figure out the potential cost based on the way you plan to use the card.

Gift cards are more personal than giving a check (you can choose a card for the recipient's favorite store or restaurant, and some allow personalization), while still allowing the recipient to choose exactly what he or she wants. They're easy to send by email or mobile phone, and they're also safer than cash if you register them with the issuer online.

While registered cards can be replaced, there may be a fee. There could also be a purchase fee, paid by the person who buys the card. (Retailers are no longer allowed to assess dormancy, inactivity or service fees unless the card has been inactive for at least 12 months.) Perhaps the biggest drawback to gift cards is the fact that many go unused. They also may not have adequate protections for fraud or theft. And if the issuing company files for bankruptcy, outstanding cards can become worthless.

Choosing the right card

Not everyone will have all payment card options available to them—for example, if you don't have a positive credit history, you can't get a charge card—but many consumers will have more than one option. Choosing the best card for any transaction requires thinking about your goals.

Cost. It's safe to say that all cardholders would like to avoid, or at least minimize, transaction fees. To do that, you need to understand the fee policies of both the card issuer and the merchant you are patronizing. For example, credit card issuers charge a transaction fee that could be as much as 5 percent for each cash advance, plus interest begins to accrue immediately. If you have a checking account debit card and enough money in your account, you can get cash for free by making a withdrawal at a network ATM or getting "cash back" at the grocery store. Other potential transaction fees include merchant surcharges for using a debit or credit card, and "convenience" fees for using a card to pay taxes or other government agency bills.

Personal finances. If you want to avoid the possibility of spending money you don't have, accumulating debt or having to pay interest on your purchases, you could use a debit or prepaid card rather than a credit card. On the other hand, if you need something—such as an urgent car repair—and don't have the cash for it, a credit card will get you out of a bind. If it will take you a while to pay off the balance, use the card with the lowest interest rate. If you know you'll have the cash to pay off the purchase in full when the bill comes, choose the card that offers the longest grace period (a short, interest-free loan) or the best rewards.

Benefits. Card benefits can range from rental car insurance and extended product warranties to merchant discounts and rewards. All else being equal, use the card that offers the rewards or benefits that would be most valuable to you for a particular transaction. Be careful not to spend more than you otherwise would just to try to maximize rewards—finance charges on revolving debt quickly wipe out the value of any cash rebates, points or airline miles you earn.

Consumer protections. Credit cards are your best option for making purchases online or with unfamiliar merchants as they offer the greatest consumer protections by law, including the right to withhold payment on a disputed transaction and a $50 limit on your liability for fraudulent transactions. Debit cards also limit your liability, but the amount you are responsible for increases the longer you wait to report the card missing, and you don't have the same dispute rights. Prepaid card issuers promote their cards' "zero liability" policies, but this protection is voluntary (not required by law) and can be changed at the card issuer's discretion.

Learn more

Visit KnowYourCard.org (www.knowyourcard.org) for an online payment card "rulebook." You'll find everything you need to know about each type of card, as well as a list of tips for smart card use.

Learn more about building good credit from Consumer Action's "Good Credit" education materials (www.consumer-action.org/modules), available in English and Spanish.

The FDIC's "Quick Guide for Consumers on Credit, Debit, and Prepaid Cards" (1.usa.gov/M5Le8m) provides a side-by-side comparison of the consumer protections provided by each type of card.

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