Variable Rate vs Fixed Rate Credit Cards

Smart consumers know to shop for
credit cards based on the cost of using that credit. The card's annual percentage rate, or APR, is often one of the first factors many consider when choosing a card. All credit cards either have a fixed or variable rate, and understanding the difference between the two can prepare consumers for the possibility of a change in their credit card's current APR. Some credit cards may be a combination of both; it may have a fixed rate for purchases and a variable rate for cash advances and default rates.

Variable Rate Credit Cards

The vast majority of credit card issuers offer variable rate credit cards; the APR of a variable rate card will fluctuate and is directly tied to an index. You can't choose the index that you want your credit card's rates to be tied to, but knowing which one is used for your credit card can help you understand the fluctuations in your card's APR. Credit card rates are commonly adjusted monthly but some may be adjusted quarterly; check your Cardholder Agreement for a detailed explanation of how often your card's APR may change. Also, even though the rate is tied to the index, most credit cards have a minimum rate, or floor, meaning you will still pay at least a certain rate of interest no matter how low the index goes.

Most variable rate cards are based on the U.S. Prime Rate. The Prime Rate is the interest rate that banks charge their best commercial customers for short term loans. The Prime Rate is updated daily in the Wall Street Journal, though it may only actually change once in six weeks. The Prime Rate is a widely used benchmark, and many credit card issuers as well as mortgage lenders use this rate to set their interest rates. Your Cardholder Agreement will explain how to get your card's current interest rate, such as Prime Rate plus 7%. If the current Prime Rate is 7.5%, plus the margin of 7%, then your card's current rate will be 14.5%.

A few
credit card rates are tied to the London Interbank Offered Rate (LIBOR), which is determined by five major banks in London. The LIBOR is the rate at which those banks will make loans to each other for specific loan maturities. The LIBOR is an index used across the world for commercial loans and mortgages. Some lenders and credit card issuers prefer the LIBOR benchmark because it is updated daily and can allow a lender to more easily recoup the actual cost of loaning the money at the current rates. LIBOR rates may change daily, but the changes are often in much smaller increments than Prime Rate changes. Even if the LIBOR rate changes daily, your APR will only fluctuate as often as spelled out in your cardholder agreement. Computing your current APR will be explained in the cardholder agreement, such as LIBOR plus 11%. The LIBOR rate is also updated daily in the Wall Street Journal.

Fixed Rate Credit Cards

Fixed rate credit cards do not fluctuate with the rate indexes. They will often carry the same APR for quite a while. How long that actually will be isn't something we can really know because credit card issuers have the right to change the card's APR at any time, for any reason. All they are required to do is to notify the cardholder in writing 15 days before the rate change. They might have a hard time making a profit and staying in business if they continually loaned out money for less interest than they had to pay themselves, so it may be financially necessary for credit card issuers to periodically review their offered rates and make adjustments to them when needed.

If you no longer want a certain credit card due to a notification of an increase in the APR, contact your credit card issuer immediately to let them know that you don't want to keep the account open under the new terms. They may allow you to pay off your remaining balance at the original rate, as long as you don't use it anymore. If you use that card at all after receiving notification, you are automatically agreeing to the change in terms and are committing yourself to the increased interest rate.

The good news is that fixed rate cards don't change often, and you may have a fixed rate card that still has the APR you originally applied for. Credit card issuers know that consumers who are attracted by a low fixed rate will be driven away from a card that constantly raises its APR. If they are offering a low fixed rate in a market of rising interest rates, they are likely to swallow the cost for a while to keep their customers. When they do increase the rate, they are likely to increase the rate more dramatically to make up for doing it less often.

So which is better?

Most consumers don't shop for a card based on whether it is a fixed or variable rate card. We usually look for things like no annual fee, generous rewards, and a low APR, regardless of being a fixed or variable APR. We find the card that offers what we're looking for, and have no choice but to accept the type of rate the credit card issuer gives it.

Credit card issuers are fond of the variable rate because it allows them to charge customers for the use of money based on current rates. Many credit cards offer rewards and other perks, so it's important for the card issuer's business health to be able to recoup actual costs more effectively. Also,

many consumers have no loyalty to the credit card companies; we will often drop one card quickly as soon as we find a card with better rates. They can't count on us to still be their customer even next year, so they are better off if they charge an APR based on current rates rather than suffer long enough for us to cancel our account before they decide to raise the fixed rate. It's not personal, just business. Right? Both consumers and the credit card issuers are just doing what makes the most sense for them financially, so variable rate credit cards are becoming the norm.

A variable rate card can be a better choice when the interest rates are falling, and a fixed rate card may be better when interest rates are increasing. But it's important to know what you are currently paying on any card at any given time; a great fixed rate card may still have a lower APR than a variable rate card, even in a market of falling interest rates. Many consumers have several credit cards, and it's a good idea to check your current rate for every card when you get each month's statement. It's possible you made a late payment without realizing it or unknowingly went over your limit for a short time and got hit with the card's default rates. Those default rates can be pretty steep, so you want to be aware of it as soon as possible so you can pay it off as fast as you can.

The best strategy for any consumer is to pay your balance in full before the end of the grace period, every month for every card. Then it really doesn't matter what the card's APR is or whether it is a fixed or variable rate.

About the Author

Finance Globe is a professional contributor of personal finance publications. All inquiries pertaining to this aricle should be submitted to them.

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