Before You Say No to a Credit Card With Annual Fees, Do This First

Description

An annual fee is what some credit card providers charge to cardholders in exchange for more perks, bigger welcome bonuses, and higher earn rates. Not all credit cards have annual fees, which makes many people wonder — why would you pay a fee to use a credit card?

It all comes down to one thing — higher rewards.

When paying an annual fee is worth it

A card with an annual fee can actually earn you more rewards card or cashback than a card with no fee. That's because these cards typically come with higher earn rates. If you spend enough, the rewards that you earn will outweigh the annual fee.

But that's the trick. You have to earn more than the annual fee itself.

For example, let's say you're looking at a cashback credit card with an annual fee, let's call it Card Y. This card offers 3% cashback on all restaurant expenses with an annual fee of $120. In order for Card Y to be worth its $120 fee, you'd have to spend at least $4,000 at restaurants per year. At $4,000, you'd earn $120 in cashback, and you'll break even.

But that's not the end of it. You also have to consider what your opportunity cost is, that is, what you're missing on a card with *no* annual fee.

So, let's say, in addition to Card Y, you're also looking at Card Z. Card Z has no annual fees and an earn rate of 1%. If you spend $4,000 on Card Z, you'll earn a flat $40. Without the annual fee, that's a $40 profit.

So, to recap, at $4,000, you earn nothing on Card Y ($120 – $120 = $0) and $40 on Card Z. So far, the card with no annual fees is winning.

At what point does Card Y become more profitable? The calculation is fairly simple. Here's the formula:

Annual Fee / (Difference in Rewards) = Breakeven Point

So, for our example, we have a $120 annual and a 2% difference in rewards (3% – 1%). If we plug this into our formula, then we get $6,000. At $6,000 you'll earn $60 on Card Z (no annual fee), and you'll earn $60 on Card Y ($180 in rewards minus the $120 annual fee).

The moment you earn more than $6,000 (in this scenario), you know Card Y is more profitable than Card Z.

When an annual fee is a bad idea

For one, if you're on a budget, I would stick to a card with no fee. A card with an annual fee might tempt you to spend more than you can afford, especially if you're trying to make the card worth the cost.

Second, I'd avoid cards with annual fees if you regularly carry a balance on a credit card. When you carry a balance on your card, meaning you don't pay your balance in full and on time for a billing cycle, you'll incur interest. Since the interest rates on credit cards can be extremely high (from 19.99% to 30%), you could easily find yourself accumulating more interest charges than any rewards program could ever help you earn.

Finally, if you're happy with your no-fee card, then maybe a card with an annual fee isn't worth it. Of course, I would do the math just to be sure. If a card with an annual fee helps you earn more rewards, it might be worth biting the bullet and paying the fee.

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