Debt Management: Consumer Credit

You have probably heard or used one or more of the following phrases: “Charge it!”, “Cash or credit?”, “Put it on my account”, etc. These phrases indicate that the use of credit is a fact of life and therefore an integral part of personal financial planning.

Debt management is the active organization of debt, to enhance both lifestyle and net worth. When you use credit, you satisfy certain needs today but will have an obligation to pay for this satisfaction in the future. While credit is a valuable financial planning tool, it requires careful management. When used effectively, credit can help you have more and enjoy more. When misused, it can result in default, bankruptcy and loss of creditworthiness. The purpose of this article is to discuss consumer credit financing with an emphasis on credit cards.

The Basics

Credit is the ability to purchase goods or services in exchange for a promise to pay at a future date. When you borrow money, the lender provides credit to you and you agree to repay the loan in the future. Therefore, debt can be defined as money owed to another in accordance with an agreement.

The person who borrows the funds is called the ***debtor.*** The person to whom the funds are owed is called the ***creditor.*** The main purposes of using credit are to:

- satisfy an immediate need while paying for the satisfaction in the future, and
- increase the value of assets, such as real estate or investments on the basis that the return on your assets exceeds the borrowing costs.

Types of Credit

There are many types of credit available to consumers in Canada. Types of credit can be categorized as follows:

- **Consumer financing or credit:** borrowing money to purchase consumer goods or services.
- **Mortgage loan:** borrowing money to finance the purchase of real estate.
- **Investment loan:** borrowing money to invest in securities or for business purposes.

Consumer Credit

Consumer credit is the extension of credit (i.e. loans) to individuals and families for personal or household use. Consumer credit is based on trust and in people's ability and willingness to pay their bills when they become due and repay the credit in accordance with the terms on which it was made available.

The following types of consumer credit financing are available in Canada:

Open Account Credit: This is by far the most common type of credit available to Canadians. This type of credit is extended to consumers in advance of any payment transaction. For example, in April you pay a bill for hydro that you used in March. This reflects the hydro company allowing you a one-month charge account. Other examples include accounts for your telephone, cable television, water, natural gas and other utilities.

Charge Card: A charge card, such as a Diners Club card and some American Express cards, allows you ("the cardholder") to charge purchases up to a specified limit. However, you are expected to pay off the entire balance in full by the statement due date. This feature is what distinguishes a charge card from a credit card. If you do not pay the full amount within the specified grace period, a late payment penalty will apply generally at a high interest rate (usually around 30%). In addition to the high interest rate, charge cards often have a high annual fee.

Credit Cards: A credit card such as VISA or MasterCard is a revolving credit card with a specified limit. If there is a balance owing on the credit card the holder must make a minimum monthly payment. This monthly payment is usually the greater of 3% to 5% of the outstanding balance or a dollar amount. Depending on the type of credit card, the interest rate charged on outstanding balances owed can be high.

Credit Card Issuers

There are three classes of credit card issuers who provide credit cards with different characteristics.

A summary of the issuers and features associated with their credit cards are as follows:

Financial Institutions: Banks, trust companies and credit unions usually issue credit cards (e.g. VISA or MasterCard). Some of these credit cards have annual fees while some "no frills" cards do not.

- If the full balance owed on the credit card is paid by the due date shown on the credit card account statement, no interest is charged.
- If the full balance is not paid by the due date shown on the credit card account statement, interest will be calculated on the outstanding daily balance owed on the credit card account from the posting date of purchases to the credit card account.
- Cash advances are usually offered on most financial institution credit cards, however, interest usually accrues from the time you accept the cash and there may also be a transaction fee.

Retail Stores: Credit cards issued by retail stores such as The Bay, Canadian Tire or Sears, usually have no annual or transaction fees. However, the interest rates charged on outstanding balances are generally high, sometimes as high as 28% per annum. The interest charged on these credit cards is calculated monthly on the outstanding statement balance, net of any payment made against the account balance.

Gasoline Retailers: Credit cards issued by gasoline retailers such as Petro Canada or Esso usually have no annual or transaction fees. The interest rates charged on these credit cards are also high, but may be slightly lower than the interest charged on retail store cards.

When choosing a credit card the following features should be assessed carefully:

Features	Consideration
Annual Fee: ▪ Fixed flat fee payable each year.	▪ Ideally, you should select the card that charges the lowest annual fee. ▪ If you intend to carry balances past the payment due date, then you may select a card with a higher annual fee and a lower interest rate (annual fees are charged once a year). However, the cost-benefit analysis of this strategy must be assessed.
Grace Period: ▪ A "free-loan" period, typically 20 - 30 days from the date the monthly statement is issued. ▪ Cards issued by financial institutions start their interest calculation on the posting date (when the purchase transaction with the card is posted in the system). ▪ You must pay off the entire amount owed on the card by the payment due date to avoid paying interest on the daily account balance from time purchase transactions are posted to the account.	▪ If you intend to pay your account in full each month, deal with a financial institution with a longer interest-free grace period. ▪ With a grace period of 25 days, you actually get a free loan when you pay the account in full each month.

Additional Features: - Relates to extra benefits offered by your card issuer.	- Free life insurance up to a specified limit. - Air Mileage entitlement. - Cash Rebates. - Auto Collision insurance. - Roadside assistance. - Cash Machine linkage for cash advances. - Greater credit availability. - Supplementary card options.

Revised 25/10/2011