

Debt Management: Consumer Credit

You have probably heard or used 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 Basics

Credit is the ability to purchase goods or services in exchange for a promise to pay at a future date. So, 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 purpose of using credit is to:

- Satisfy an immediate need while paying for the satisfaction in the future.
- Increase the value of assets, such as real estate or investments on the basis that the return on investment 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.

The purpose of this article is to discuss consumer credit financing with an emphasis on credit cards.

Consumer Credit

Consumer credit is the extension of credit 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.

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 transaction. For example, in April you pay a bill for hydro that you used in March. Typically, a retail outlet or utility company allows you a one-month charge account for phone bills, cable bills or utility bills.

Charge Card: A charge card, such as a Diners Club card or 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 a 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, annual fees for charge cards are usually high.

Credit Cards: A credit card such as VISA or MasterCard is a revolving credit with a specified limit. You must make a minimum monthly payment. This monthly payment is usually the greater of 3% to 5% of the outstanding balance or a dollar limit. Depending on the type of credit card you have, interest charges can be relatively high.

Credit Card Issuers

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

A summary of issuers and the features associated with their credit cards follows.

Financial Institutions: Banks, trust companies and credit unions usually issue credit cards (e.g. VISA or

MasterCard). Some cards have annual fees while some “no frills” cards do not.

- If the full balance is paid by the statement due date, no interest is charged.
- If the full balance is not paid by the statement due date, interest will be calculated on the daily balance from the posting date.
- Cash advances are usually an attractive option; however, interest usually accrues from the moment you accept the cash and you must also pay 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, interest rates charged are very high, sometimes as high as 28% per annum. Interest is calculated monthly on the statement balance, net of payment made.

Gasoline Retailers: Credit cards issued by gasoline retailers such as PetroCanada or Esso usually have no annual or transaction fees. Interest rates on these cards are high but are slightly lower than retail store cards

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

| Features | Consideration |
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| <p>Annual Fee:</p> <ul style="list-style-type: none"> • Fixed flat fee payable each year. | <ul style="list-style-type: none"> • Ideally, you should select the card that charges the lowest annual fee. • If you intend to carry balances past the statement due date, then you may select a card with higher annual fees and a low interest rate (annual fees are charged once a year). The cost-benefit analysis of this strategy must be assessed. |
| <p>Grace Period:</p> <ul style="list-style-type: none"> • A “free-loan” period, typically 20 - 30 days. • Cards issued by financial institutions start their interest calculation on the posting date (when the transaction is posted in the system). • You must pay off the entire amount owed on the card by the statement due date to avoid paying interest on the entire amount for that billing period. | <ul style="list-style-type: none"> • If you intend to pay your bill in full monthly, deal with a financial institution with an interest-free grace period. • With a grace period of 25 days, you actually get a free loan when you pay bills in full each month. |

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| <p>Additional Features:</p> <ul style="list-style-type: none">• Relate to extra benefits offered by your card issuer. | <ul style="list-style-type: none">• 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. |
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