Lesson 5: Credit and Debt

In February 2006, the Vanier Institute for the Family released a report on the state of family finances in Canada. The report warned that Canadian families are accumulating financial **debt** at an alarming rate. The average family today owes 140 percent of its gross household income.

You may also have noticed media reports about Canadian students graduating from university with higher and higher levels of debt, often $10 000 or more.

What is the reason for this high debt? Canadians are spending money they don't have. Instead, they are relying on **credit**.

In this lesson you will examine some issues surrounding credit and debt—specifically, **credit cards** and loans.

debt: *something owed to a person or an organization*

credit: *the privilege granted to approved clients to receive goods or services and to pay for them in the future*

credit card: *a bank-issued card that allows the cardholder to purchase goods or services from a merchant on credit*

Credit Cards

Does anyone in your family use a credit card? In today's electronic society, a credit card is almost a necessity. It makes many financial transactions easier. You need a credit card to rent a car, make reservations at a hotel, and shop online or by phone.

Did You Know?

Credit cards are not new. They have been around for almost 100 years. Before 1970 they were rare, and the number of businesses accepting them was limited. Since then they have become easier and easier to get. Now their only rare feature is the number of businesses that *do not* accept them. The first credit cards were made of metal or cardboard. Why do you think today they are referred to as *plastic money*?

You might be offered student credit cards, but think twice before accepting one if you do not have a steady income. Card-issuing companies make sure their cards are very convenient. They know that the easier it is to use a card, the more likely you are to make a purchase—and on top of that, you will spend more than if you were using cash.

A credit card can save you money if used wisely, for example, if you take advantage of bulk purchases or sale items and pay off your balance each month. But the opposite is also true: a credit card used carelessly can cost you money and land you in debt. The reason lies in the card's convenience; you may be tempted to overuse it or buy what you really cannot afford. Purchases quickly add up to more than you can repay in a month, and then you owe steep **interest** charges on top of your unpaid balance. This interest is how the company makes a profit from your card.

interest: *payments made by a borrower for the use of a lender's money, often expressed as an annual percentage*

There are three basic types of credit cards:

- ***Bank cards.*** These are cards issued by banks; the two major bank cards are Visa and MasterCard. Both are widely accepted.

- ***Travel and entertainment cards.*** These include cards such as Diners Club and American Express. These are not as widely accepted as bank cards, because they were designed for use in high-end establishments.

- ***House cards.*** Large consumer stores, such as Sears, The Bay, or Canadian Tire, offer these cards. House cards can only be used within a specific chain of stores. Cards from fuel companies such as Petro-Canada often work in a similar way.

Sometimes a card carries the logo of an organization or a business in addition to the lender's emblem. This type of card is known as an *affinity card,* a *value-added card,* or a *rewards card*. Its use provides either of two kinds of benefits:

- Cardholders receive some sort of benefit. For example, they may receive points toward merchandise, travel, or fuel.

- The designated organization, or *affinity partner*, receives a donation. Affinity partners include universities, sports teams, and charities.

credit limit: *the maximum amount of money that can be charged on a particular credit account*

revolving credit: *a type of credit that does not have a fixed number of payments but requires a minimum monthly payment*

Most credit cards give cardholders a **credit limit** and offer them what is known as **revolving credit**. This means they let you carry a balance on which they charge interest (finance charges), and they require you to make minimum monthly payments.

A few credit cards, such as American Express, require you to pay off all of your charges each month. As a bonus, these cards usually have a very high credit limit.

annual percentage rate (APR): *the interest rate reflected as a yearly rate*

grace period: *the interest-free time a lender allows between the transaction date and the billing date*

transaction fee: *a fee charged each time the cardholder makes a purchase with a credit card*

annual fee: *a fee charged every year by the credit card issuer for the cardholder's right to possess and use the card*

late-payment fee: *a fee charged for failing to submit the minimum monthly payment by its due date*

Following are other points to consider when you compare credit cards:

- **annual percentage rate (APR)**
- **grace period**
- fees, such as **transaction fee**, **annual fee**, and **late-payment fee**

To gain a better understanding about the type of credit you get with credit cards, read the following articles in *Venturing Out*:

- "A Holiday Credit Saver" on pages 49 and 50 explains credit cards, interest rates, annual fees, grace periods, value-added cards, debit cards, getting out of credit-card trouble, and matching credit-card type with lifestyle.

- "Rating Our Plastic Pals" on pages 88 and 89 compares some ways you can use credit cards wisely.

- "An A+ or an F?" on page 90 provides a particular perspective on credit use. It examines the way people purchase on credit to gain instant gratification; the true cost of credit to the borrower; and some background on the use of credit cards and credit in general.

- "FAQ: 10 Ways to Protect Your Credit Cards" on page 94 outlines important steps you can take to protect yourself from credit-card fraud.

1. What are the advantages and disadvantages of credit cards?

2. What are the advantages and disadvantages of debit cards?

3. Kristof accepted several student credit cards and now has a difficult time with them. He rings up lots of charges on all the cards, has high balances on each one, and struggles to make the minimum payments required each month.

   a. How would you advise Kristof about what he should do now?

   b. List the problems teens can have if they don't understand what it means to create credit-card debt.

   c. List some positive reasons for a teen to have and use a credit card.

Compare your answers with the Suggested Responses at the end of the lesson.

Your Credit Rating

credit history: *a record of an individual's debts and payment patterns*

credit rating: *an assessment of a person's ability to handle the financial burden of credit at a particular time*

Every time you apply for or receive credit, and every time you make or do not make a payment on time, you are building your personal **credit history**.

Credit agencies, such as Equifax Canada and TransUnion Canada, regularly collect credit information from all the companies that provide credit to you. Each of these companies assigns you a **credit rating** for each transaction it has with you.

You do not have one overall credit rating. Rather, you have a file of credit history with a rating from each company that has granted you credit. In total, these ratings make up your *credit file*. The ratings that creditors give may range from R0 to R9—the lower the number, the better the rating. Following is an explanation of the ratings.

Number	Credit Account Rating
R0	Too new to rate; approved but not used
R1	Pays (or paid) within 30 days of payment due date or not over one payment past due
R2	Pays (or paid) in more than 30 days from payment due date, but not more than 60 days, or not more than two payments past due
R3	Pays (or paid) in more than 60 days from payment due date, but not more than 90 days, or not more than three payments past due
R4	Pays (or paid) in more than 90 days from payment due date, but not more than 120 days, or four payments past due
R5	Account is at least 120 days past due but is not yet rated R9
R6	No rating exists
R7	Making regular payments through a special arrangement to settle debts
R8	Repossession (voluntary or involuntary return of merchandise)
R9	Bad debt; placed for collection; moved without giving a new address

Read “Take Some Credit” on pages 25 and 26 of *Venturing Out*. This article discusses personal credit ratings and ways in which they can be damaged.

4. Establishing and maintaining a good credit rating creates an important asset that you want to protect. What are some actions you can take to protect your overall credit rating?

Compare your answer with the Suggested Responses at the end of the lesson.

Your good credit rating is an important asset.

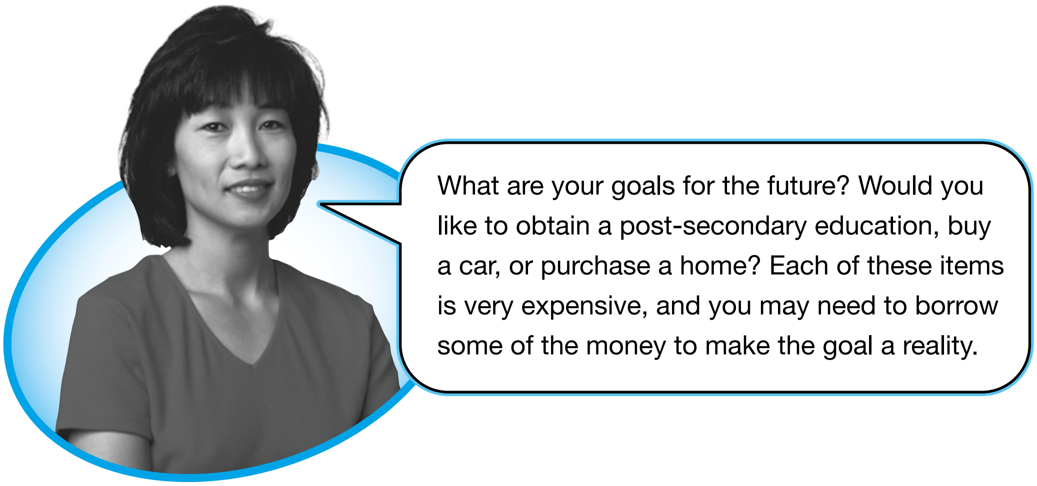
For a comprehensive summary on what credit is, the forms it takes, and its advantages and disadvantages view Segment 13: Credit on your Student Support CD.

Did You Know?

Credit Counselling Services of Alberta is a non-profit, consumer debt counselling service. The counsellors educate Albertans in personal money management and the wise use of credit. They also provide alternatives for individuals and families facing financial crises. For more information call toll-free in Alberta 1-888-294-0076, or visit the following website:

http://www.creditcounselling.com

Loans



At one time or another, most people turn to a financial institution to obtain a loan. In this part of the lesson, you will examine the lending process.

Usually when you apply for a loan, the lender evaluates your credit application and looks at three points, commonly referred to as *the three Cs*:

- ***Character.*** A lender wants to know if you are responsible enough to repay the loan. To judge your character, the lender reviews your credit history, length of residency, and length of employment.
- ***Capacity.*** A lender wants to know if you can afford to repay the loan. To evaluate your credit capacity, the lender reviews your earnings, current debts, and other financial commitments.
- ***Capital.*** A lender wants to know if you have any capital—savings, investments, real estate, or valuable possessions, such as an automobile—that could be used to repay the debt if your income is unavailable.

5. Imagine that you are meeting with the loans manager at a bank and you are asked the following questions. Which of the three Cs is being judged in each?

a. How long have you lived at your present address?
b. How long have you been at your current job?
c. What is your current salary?
d. How much money do you have in savings?
e. How much do you currently owe?

Compare your answers with the Suggested Responses at the end of the lesson.

net worth: *the value of all assets, including cash, minus all liabilities*

asset: *anything with monetary value that a person owns*

liability: *debt; anything that is owed to someone else*

When you apply for credit, lenders often consider your **net worth**—your **assets** minus your **liabilities**. Simply speaking, your net worth is the value of all you have minus all you owe. It is what you would have left if you cashed in everything you own and paid off all your debts. Assets and liabilities include the following:

Assets	Liabilities
• vehicles • savings accounts • Canada Savings Bonds • other investments, such as RRSPs • items of value, such as a TV or computer	• loans, such as student loans, bank loans, or money owed to family • any outstanding amounts, such as unpaid bills, taxes, or credit-card balances

Did You Know?

Do you know your personal net worth? If you figure it out about once a year, you will find it useful in a number of financial situations. It may track your progress as you pay off a debt or save for a large expense like tuition or a down payment. It can help you observe whether your net worth is developing a pattern of growth over time. This may help you decide when you can afford a certain purchase and perhaps speed up your dealings during a loan application.

co-signer: *the person who signs a loan agreement along with the borrower and assumes equal responsibility for repayment*

collateral: *an asset that a borrower pledges as a guarantee of loan repayment*

If you do not immediately meet a lender's criteria for granting a loan, you may still qualify for a loan if you can do one of the following:

- Find a creditworthy person to co-sign the loan. This involves a situation of great trust because the person is trusting you to follow through with your financial commitment. If you fail to make your loan payments, the **co-signer** then becomes responsible.

- Provide **collateral** to secure the loan. If you fail to make your loan payments, the lender can then seize the collateral.

Loan Terms and Conditions

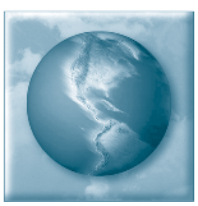
If you do meet a lender's criteria for granting a loan, you will want to negotiate the best financing deal possible. As you negotiate financing for a loan, the financial institution will set out certain terms and conditions, including the following:

principal: *the total amount of money borrowed and left owing to the lender, decreasing over time as the loan is repaid*

- repayment options for the **principal** (amount borrowed) plus interest
- the interest rate, which could vary
- when repayment begins
- when all the payments are due
- amounts of all payments
- how to make payments

You may want to shop around and compare the financing options of several lenders. Consider their interest rates, loan terms, down payments, and monthly payments. Be aware of the following facts about loans:

- The more you repay each month, the shorter the term, or length, of your loan.
- Interest rates could vary depending on where you get a loan, what you intend to use it for, and how well a lender knows you.
- Some loans involve penalty fees for repayment amounts bigger than in the original agreement.
- If you miss a payment, you will be *in default* and your ability to get further credit will be damaged.



For clear explanations of terms in the loan-application process, go to the following website. Click on *Loans*, and in the dropdown menu, click on *Loan Dictionary*.

http://www.westoba.com/

6. **a.** Explain why it would be to your advantage to shorten the term of your loan by agreeing to make repayments as large as you can afford each month.

b. Why do you think some loan agreements include penalty fees for repaying faster than in the original agreement?

7. Research the Canada Student Loan program. Then explain how the government of Canada has ensured that students in financial need can obtain a student loan.

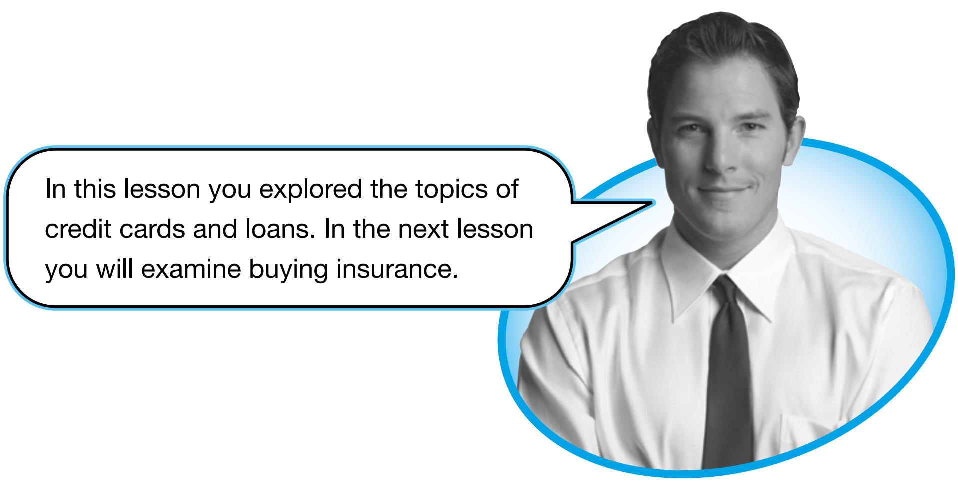
Compare your answers with the Suggested Responses at the end of the lesson.

The Canada Student Loan program has another important advantage to students; they will not begin repaying the loan until after they complete their education.

View Segment 14: Handling Money Problems on your Student Support CD. You may wish to view this segment several times to identify the trouble signs of poor money management and the steps to take to get out of financial trouble.

Go to page 15 of Assignment Booklet 2A and respond to question 10 of Section 1.

Looking Back; Looking Ahead



Glossary

annual fee: a fee charged every year by the credit card issuer for the cardholder's right to possess and use the card

annual percentage rate (APR): the interest rate reflected as a yearly rate

asset: anything with monetary value that a person owns

collateral: an asset that a borrower pledges as a guarantee of loan repayment

co-signer: the person who signs a loan agreement along with the borrower and assumes equal responsibility for repayment

credit: the privilege granted to approved clients to receive goods or services and to pay for them in the future

credit card: a bank-issued card that allows the cardholder to purchase goods or services from a merchant on credit

credit history: a record of an individual's debts and payment patterns

credit limit: the maximum amount of money that can be charged on a particular credit account

credit rating: an assessment of a person's ability to handle the financial burden of credit at a particular time

debt: something owed to a person or an organization

grace period: the interest-free time a lender allows between the transaction date and the billing date

interest: payments made by a borrower for the use of a lender's money, often expressed as an annual percentage

late-payment fee: a fee charged for failing to submit the minimum monthly payment by its due date

liability: debt; anything that is owed to someone else

net worth: the value of all assets, including cash, minus all liabilities

principal: the total amount of money borrowed and left owing to the lender, decreasing over time as the loan is repaid

transaction fee: a fee charged each time the cardholder makes a purchase with a credit card

revolving credit: a type of credit that does not have a fixed number of payments but requires a minimum monthly payment

Suggested Responses

1. Following are some of the advantages of credit cards:

- Credit cards can make it easier to buy goods and services. You don't have to carry large amounts of cash with you. Some companies do not accept cash purchases (for example, most airlines, hotels, and car-rental agencies).

- Having a credit card and using it wisely (making payments on time and in full each month) will help you build a good credit history.

- Credit cards can be useful in times of emergency. For example, if your car breaks down while you are travelling, you may need to rent a car or stay in a motel room for several nights.

- Some credit cards offer additional benefits, such as discounts from particular stores or companies, bonuses such as free airline miles or travel discounts, and special insurance such as travel or life insurance.

- Credit cards may offer protection if something you buy is lost, damaged, or stolen.

Following are some of the disadvantages of credit cards:

- Most credit cards offer generous credit limits and don't require you to pay off your balance each month, so you may be tempted to spend more than you can afford.

- Credit card companies charge high interest rates on any balance that you don't pay off at the end of each month. This is how people get into debt or even go into bankruptcy.

- If you have a credit card you may become the victim of credit-card fraud. If someone steals your credit card or obtains your credit-card number (from a receipt, over the phone, or from a website), the thief can use your card to rack up debts.

2. Following are some of the advantages of debit cards:

- Obtaining a debit card is often easier than getting a credit card. If you qualify to open a bank account, you can usually get a debit card.

- Having a debit card frees you from carrying a lot of cash or a chequebook.

- When you use a debit card—unlike writing a cheque—you don't have to show identification or give out personal information at the time of the transaction.

Following are some of the disadvantages of debit cards:

- The convenience can be costly, especially when using an ATM that is not affiliated with your financial institution.

- Using a debit card may mean you have less protection than you would with a credit card for goods that are never delivered or are defective.

- You may become the victim of debit-card fraud.

3. **a.** Your advice to Kristof could include the following:

- work out a budget to pay off his cards, and then destroy the cards
- stop the use of credit cards until they are all paid off
- borrow money at a lower interest rate to pay off the balances on his cards
- set up a monthly payment plan for the loan
- resolve to use one credit card only after all the balances have been paid off

b. Your response may include the following:

- getting a bad credit rating
- being in debt for a long time
- not being able to get additional credit
- personal bankruptcy
- a personal loss of confidence and independence

c. Your response may be similar to the following:

- building a positive credit rating
- being able to get things right away
- having the security to use the credit card in an emergency situation
- being able to travel independently, for example, on school trips
- gaining a sense of self-confidence and maturity
- learning personal money-management skills
- beginning to take on the responsibility of living on your own

4. You can protect your credit rating by paying bills on time and limiting the debt you acquire.

5. **a.** character
b. character
c. capacity
d. capital
e. capacity

6. **a.** It is to your advantage to make loan repayments as large as you can afford each month so you can pay back your loan as fast as possible. The sooner you repay a loan, the less it will cost you in interest charges.

   b. Some loan agreements include penalty fees if you repay faster than in your original agreement because the lending institution is losing some of the interest it was expecting to earn from your use of its money. Interest savings are a gain for you but a loss for the lender.

7. The government of Canada guarantees the Canada Student Loan program. This ensures that students in financial need are approved for student loans without providing collateral or a co-signer.

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