

Understanding Credit

Learning About Money

What is credit?

Simply put, *credit is buying now and paying later—for a fee*. The fee you pay includes interest on the money borrowed and any service charges.

Credit is like a two-sided coin. On one side it allows you to have and enjoy goods and services now and pay for them later. On the other side, it can tempt you to overspend and may result in financial problems.

Consider the advantages and disadvantages before using credit. This fact sheet will help you understand what credit is and how it works. It also talks about what you can do if you get into debt. Learning to use credit wisely is a good thing!

Credit—can you afford it?

Today many consumers believe credit is essential. For some, it has become part of their everyday spending. This is because we use credit in so many ways. For example, when you use the phone, heat or electricity in your home and pay the bill at the end of the month you are using credit. If you are paying a mortgage on your home you are using another type of credit. The same is true if you have a loan for a car, school or the purchase of furniture then you are also using a form of credit.

So, what amount of credit can you afford? The answer to this question will depend on your income, expenses and financial goals. However, many financial educators agree it is wise to keep personal credit payments for loans at not more than 15% of take home pay. This does not include a mortgage payment. By not borrowing more than this amount of money, you will be able to save and pay for things in the future. Companies may offer you much more credit than this—but think about whether you really want to borrow more of your future income.

Before you sign . . .

Here are some *questions* to ask yourself before signing any credit agreement.

This resource has been developed by:
Basic Skills for Living Project
Manitoba Association of Home Economists—
Winnipeg Branch
Box 1961
Winnipeg, MB
R3C 3R2 Canada
Phone: (204) 253-3563
Email:
info@basicskillsforliving.ca



- What is the total dollar amount of the loan?*
- How much is the monthly payment?*
- What is the annual rate of interest?*
- Are there any insurance charges or other fees?*
- What is the total dollar cost of the credit contract?*
- What will happen if I cannot pay?*
- Can I afford this debt?*

Establish a credit rating



In order to borrow money at a low interest rate you need to have a **good credit rating**. By having a good credit record a lender knows you will pay them back.

Remember—credit is a privilege—not a right. It is the consumer’s responsibility to earn that right . . . A credit grantor expects a consumer to meet the **four C’s of Credit**. These include:

- **Character**—your character is good if you have a history of paying your bills on time.
- **Capacity**—your capacity to pay off bills grows in direct relationship with income. However, all debts and financial commitments will be taken into consideration.
- **Capital**—capital is measured by how much you actually own, i.e. net worth.
- **Collateral**—this is anything of value that you can offer as security against a loan.

To establish a credit rating there are several things you can do. Here are some of them:

- Open a savings account and make regular deposits. When you have enough money saved for a particular purchase then apply for a personal loan to purchase the item. Use the savings account as the collateral for the loan. Repay the loan with deductions from the savings account over a six month period so as to establish a credit record. Ask the lender to have the loan recorded with their Credit Bureau.
- Be sure to pay rent and your utility bills in full and on time—by their due dates.
- Repay loans as soon as possible. Remember this saves you money in the long run.
- Take on no more debt than you can comfortably afford. Borrow the **least** amount that you need.
- Repay credit card balances in full and by the due date when possible.

See the **Consumer Education series** for information about checking a credit record and other topics.

Set spending limits

When does it make sense to use credit? To be a smart shopper **set limits for yourself**. First, start by making a budget and sticking to it! This way you will not overspend and will use credit wisely.

Secondly, limit the number of credit cards you have—many advisors recommend not more than two credit cards. In most cases **one card** can provide all the purchasing power you need. In choosing a card consider such things as the annual fee, the annual rate of interest (ARP), and any late fees or special options.

You may need a second card if you have business expenses with your job. It is a good idea to keep your personal and business expenses separate.

Consider never charging more than you can pay off in the month. There may be times when this is not possible because of a larger purchase. In such cases, plan for these expenses in your budget so you know when it will be paid off.

Do not carry your card unless you have planned a purchase. This can help you avoid impulse buying and overspending. **Do not buy things you do not need!**

Keep track of every purchase and then check your receipts with your monthly statement. This way you will know what you owe. Also check for any charges that may not be yours in case of mistakes or credit card fraud.

What is the cost of credit?

Here is a quick way to figure out what credit costs . . .

$$\begin{array}{r}
 \$ \text{ ______ } \text{ monthly payment} \\
 \times \text{ ______ } \text{ number of months to pay} \\
 = \$ \text{ ______ } \text{ total amount to be paid} \\
 - \$ \text{ ______ } \text{ purchase price of the item} \\
 = \$ \text{ ______ } \text{ cost of credit}
 \end{array}$$

What is the cost of credit?

What is the total cost of the loan?

Too much debt?

Are you having trouble making ends meet? Maybe it is time to take a closer look at your finances. Start by asking yourself the questions below to find out if you are overspending.



1. Do you often make partial payments instead of paying a bill in full when it is due?
2. Do you use a credit card instead of cash for small purchases?
3. Is your chequing account ever overdrawn?
4. Are you often broke on payday?
5. Are your credit cards near their credit limits?
6. Would an unexpected expense cause you hardship?
7. Do you sometimes buy things you really don't need or want?

If you answered “**yes**” to many of these questions then this is a **warning sign** that things are getting out of control.

Where does your money go?

So, here is how you can take control! First, you need to find out where your money goes and find out how much you may be overspending.

Start by keeping track of your income and expenses. Record all your payments. You may want to use a worksheet and the forms in the **Spending Plans** module of this resource. These are a good guideline. Keep track of every penny for the month. By filling in a worksheet and the forms you will have enough information to see where to make changes in how you handle money.

Follow the steps in the worksheet. Once you have collected all your data—decide what expenses you can cut back. What do you really **need**? Think about whether there is a way to **increase your income** so as to pay down debt more quickly. Examine your spending habits—and mark the calendar so you **pay your bills on time**. Can you make your income balance with expenses and your credit payments? How much debt do you have?

Ways to get out of debt?

There are different ways to tackle a debt problem. Decide if you can set up a spending plan and manage your money—then determine if you can budget yourself out of debt.

Continue keeping track of your expenses—set up a system and a regular time to pay your bills. For example, many people find sitting down every two weeks to pay bills and keep accounts up to date is one good way. Be sure to balance income with all expenses each month and check all bank statements.

Another question to consider—can you stop using credit until you pay off all debts? If so, then find out if the **PowerPay method** may work for you to pay off debts as quickly as possible. Here is how it works.

The PowerPay Method

Begin by seeing what your total debt situation is. Fill in **Form SP40 Tracking Loan and Credit Payments**. Decide how much you can pay for each debt monthly and get a total—it needs to be at least the minimum amount due. The information on this form is what you will need to use the **PowerPay** method.

The concept of **power payments** is that you stop borrowing until all your current debt is paid. This means that as one debt is paid off, then that monthly payment is applied to the next debt with the highest interest rate. Money from paid debts continues to be combined towards the balance owing until you are debt free. This does not include a mortgage.

This method saves in two ways—time and interest costs. To find out how you can pay your debt off quickly go to the University of Utah's website at powerpay.org



At this site you will be asked for your user name and also a password, which keeps your information confidential. You can go back to this site again if desired.

PowerPay calculates what repayment time and interest costs will be if you keep doing what you are doing now—and compares it with the **PowerPay method**. You are able to print out your repayment plan and also see different scenarios. Follow the repayment plan to get out of debt!

Financial counselling can help

Sometimes a person cannot solve a problem alone and needs help. Financial problems are no different. There are many reasons why people face a financial problem—

- sometimes one does not know how to budget his/her money wisely
- other times, it may be due to a loss of a job
- a cut back in pay, or
- a family illness or breakdown.

Sometimes we buy more than we need.

In other situations someone faces a **financial crisis** because of his/her own habits. Perhaps they have a problem with alcohol, gambling, or drugs and this causes financial hardship not only for themselves, but also for their families.

These situations can result in someone facing a cut off notice for utilities, a wage garnishment, or a collection notice from a creditor. Or, perhaps they are falling behind with their bills.

You can get help from community credit counselling services. Look for agencies that are non-profit. See a list in Canada at www.creditcounsellingcanada.ca Make an appointment to review your situation and find out what your options are.

Having an impartial counsellor review your situation can help you make decisions about how to solve a problem!

Sometimes the problem cannot be easily resolved and you may have too much debt to pay it off. If this happens then a financial counsellor can explain how the federal bankruptcy act can help you start over. This would be the last option, but there are times when it may be the right choice.

Look for help if you cannot get out of debt on your own. There are ways to solve a problem.

Acknowledgement: *This fact sheet has been revised and adapted with permission from Manitoba Agriculture, Food and Rural Initiatives, 2005.*

Other things you should know . . .



Here are several things to remember about managing credit cards. It is important to have safe habits when handling your money. These are general guidelines to help protect you from **credit card fraud** or **identity theft**.

- Shred all personal information when you no longer need it—this includes any bank information and personal information that has your name, address, birth date and your social insurance number (SIN).
- Do not carry your SIN card in your wallet. Keep it in a safe place along with other important papers that identify you. These include cheques and all banking information. (A locked place is best.)
- Be aware of banking and credit card scams and frauds that happen over the phone, TV, the Internet, and door to door sales.
- Avoid using a credit card or debt card for small purchases in convenience stores, gas bars, or movie kiosks where there is a turn over in staff. Using cash in these situations is safer.
- Follow your cards! Be sure to see what is happening to either a credit or debit card when using it to pay a bill. It should only go through one card reader and it should be in sight at all times.
- Check your monthly bank and credit card statements to ensure you are the only person using your cards.

Internet: www.basicsskillsforliving.ca

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