Part 4

Financing your goals with debt and credit

Part 4 provides information about how debt and credit can be used in positive ways to meet your financial goals. Debt is not always bad. A mortgage, for instance, is a form of debt that allows you to purchase a home or buy property. A small business loan can help you realize your dream of opening or expanding a business. “Bad debt” refers to having more debt than you can manage or pay off. “Good debt” is debt you are able to pay off that positively affects your credit score. As explained below, a good credit score means you have a demonstrated track record in repaying borrowed money. A good credit score can make it more likely lenders will approve bigger loans like a mortgage or business loan.

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First Nations Child & Family Caring Society of Canada

Part 4.1: Understanding credit

What is credit?

Credit is the ability to obtain goods or services before payment, based on trust that payment will be made in the future. A common example is a credit card.

What is a credit report?

A credit report shows your use of loans and credit cards, including information on your credit accounts, the dates they were opened, your payment history and your credit limits or loan amounts, along with your credit score inquiries.

A credit report is required when you apply for credit or other things such as a rental property. There are two main credit reporting agencies in Canada:

- TransUnion‡
- Equifax‡

Types of credit checks

- **Hard checks:** Occur when a lender requests your credit report as part of the loan application process. This will affect your credit score. Generally, if multiple checks are done for the same type of loan, in the same period of time, they will only show as one inquiry.
- **Soft checks:** Occur when you check your own credit report and score. This will not affect your credit score. The check will not show up on your credit report for lenders to see; although you will be able to see that the check took place for up to two years afterwards.

What is a credit score?

A credit score is a number between 300 and 900 that represents your “creditworthiness.” Creditworthiness is how willing a lender is to lend you money. The higher the number, the better!

Lenders generally are more inclined to give funds to those with higher credit scores because a high score shows a good track record of repaying borrowed money.

What raises and reduces credit scores?

Credit scores are based on...	Higher credit score	Lower credit score
Your payment history	You make payments on time	You make late or minimum payments
The length of time you've used credit	You've used credit for a long time	You just started using credit
The amount you owe	What you owe is way below your credit limit	You owe an amount over your credit limit
The amount of different types of credit	You have multiple types of credit (credit card, auto loan, etc.) that you've applied for over time, signaling you have experience with credit	You've applied for too many different types of credit over a short period of time
The number of credit applications you've made	You apply for credit up to a couple times a year, when needed	You apply for credit several times a year, creating too many hard checks, which can be a sign to lenders that you may have trouble paying money back

Bad credit can stay on your credit report for years. Simple ways to improve your credit score are to:

- Make payments on time
- Not go over your credit limit
- If you see false information on your credit report, dispute it with your credit reporting agency to ensure your credit score is not lower than it should be

Importance of building your credit

- Building your credit means building a positive history of using different types of credit such as loans and credit cards.
- A good credit history means you've shown you don't borrow more than you can afford and will pay back what you borrow on time.
  - Do you make payments on time and make at least the minimum payment?
  - Do you exceed credit card limits?
- A good credit history is especially important if you want to make larger purchases such as a vehicle or home, or you require a small business loan. Lenders need to trust that you will pay them back!
- Good credit can lead to reaching your short-term and long-term goals.

Credit-related terms to know

Principal

- The total amount you borrowed.
- Interest payments are based on the principal amount owed.

Principal payments

- Payment toward the original amount of money borrowed.

Term

- The length of time you have to pay back what was borrowed.

Interest

- **Annual Percentage Rate (APR)** is expressed as a percentage per year.
- Interest is the cost of borrowing the principal amount. The lender charges interest in exchange for lending you the money.

> **Example:** If the APR of a $9,000 personal loan is 10.15%, this means that the cost of borrowing the money will be 10.15% of $9,000 per year. $9000 x 0.1015 = $913.50/year in interest costs.

- Can be variable or fixed:

  Fixed means the same interest rate for the entire borrowing period.
  - **Advantage:** Protected from sudden and high increases in interest rates.
  - **Disadvantage:** No opportunity for a better (lower) interest rate when rates change.

  Variable means the interest rate changes over time.
  - **Advantage:** Possibility of a better (lower) interest rate when the bank's benchmark rate goes down.
  - **Disadvantage:** No protection from higher interest rates when the bank's benchmark rate increases.

Secured and unsecured loans

- Secured loan:
  - A loan where the borrower pledges an asset (such as a house or car) as collateral for the loan. The loan is then secured debt.
  - Taking out a secured loan can help you increase your credit score if you pay the entire loan plus interest back on time. This is because the loan is less risky for the lender since there is collateral involved. The collateral acts as a guarantee: if something goes wrong with the loan, the lender may take the asset used as collateral (such as a house or car) and will not be at a loss.
- Unsecured loan:
  - A loan that doesn't require collateral and is only supported by the borrower's creditworthiness.
  - You need a higher credit score for an unsecured loan as the loan is not secured by any collateral. The lender must be sure that you will pay the entire loan plus interest back on time, so they rely on what your past actions regarding credit tell them.
  - Unsecured loans have higher interest rates (more costly) than secured loans.

Part 4.2: Types of credit

Credit cards

- A credit card allows you to borrow funds to make purchases in person or online to build your credit score.
- A credit card offers an easy way to begin to build credit at a young age.
- It's a widely accepted form of money.

Choosing the right credit card

There are three main types of credit cards:

- Bank-issued credit cards create a deeper relationship between you and the bank.
- Store/priority credit cards can be beneficial if your spending habits at the particular store are consistent and you will benefit from the discounts or reward programs.
- Travel/entertainment cards can be beneficial if you will actively use the points and perks offered.

Making credit card payments

Make sure you are paying your credit card balance on time or you will be charged a fee. Missed payments will have a negative impact on your credit score.

To make payments towards your credit card, you can:

- Add your credit card as a "bill payee" through your bank account and pay by visiting a branch or using online, mobile or telephone banking
- Set up recurring payments or make a one-time payment
- Mail a cheque to your credit card company if your bills come by mail

Interest, minimum payments, cash advances and fees

Interest

- Expressed as a percentage and called an Annual Percentage Rate, APR or purchase rate.
- Interest is charged if the full statement balance (the total amount charged to the card) is not paid.

Minimum payments

- The lowest amount you must pay each month.
- This may be a fixed amount or calculated using a percentage.
- If you make a minimum payment, you will be charged interest.

Cash advances

- Withdrawal of cash from an ATM using your credit card.
- This is not recommended as it immediately starts accruing interest that is generally higher than the APR.

Fees

- Most credit cards have annual fees.
- Extra fees may include late payment fees, additional card fees, etc.

Example

Credit card

Annual fee for having the card:	$120
Cost of an additional card:	$50
Interest rate on purchases (purchase rate or APR):	19.99%
Interest rate on cash advances (cash advance rate):	22.99%
Outstanding balance:	$1,000

Monthly credit card interest costs

If there is an outstanding balance, which means there are unpaid funds from previous months, this amount will bear interest.

Take your APR and divide it by 12 months.

$$\frac{19.99\%}{12 \text{ months}} = 1.67\% \text{ per month}$$

This means your monthly interest rate will be 1.67%.

Multiply this percentage by your outstanding balance.

1.67% x $1,000 = $16.70

This means, if you have an outstanding balance of $1,000 from the previous month, you will have an interest cost of $16.70 for the current month you'll need to pay.

Cash advance cost

If you take out a $1,000 cash advance:

$$\text{Cost} = \text{Cash Advance Amount}\left(\frac{\text{Cash Advance Rate}}{100} \Big/ 365 \text{ days}\right)$$

$$= \$1{,}000\left(\frac{22.99}{100} \Big/ 365\right)$$

$$= \$0.63 \text{ per day}$$

Credit card tips

- Use your credit card for short-term borrowing.
- It's great for smaller purchases and online purchases.
- Do not overspend just to earn more points or rewards.
- Do not take cash advances.

Mortgage

- Used to purchase a house, apartment, condo or other property.
- A secured loan where the bank lends money to a borrower for the title of the property.
- The money must be repaid along with interest.
- Mortgage payments are paid on a regular basis at a certain date by the borrower until the entire mortgage is paid off.
- Some banks provide on-reserve housing loan programs.

Auto loan

- A borrower receives a loan to purchase a vehicle.
- This is a secured loan where the vehicle being bought is collateral until the borrower pays it off.
- Auto loans are provided by banks, car dealerships or online providers.
- Your payment is equal to a principal payment plus interest and is often paid on a monthly basis.

Personal loan

- A bank lends a fixed amount of money to an individual who agrees to repay the amount plus the interest costs.
- Payments are often on a monthly basis.
- Loans tend to be for major purchases or expenses such as weddings, or for debt consolidation.
- Can be secured or unsecured.

Line of credit

- A specified amount of money that a borrower can draw the full amount or small amounts from and must pay back along with interest.
- You only pay interest on the amount you take from the line of credit.
- Can be secured or unsecured.
- Has a flexible term (the length of time the line of credit is available for).

The difference between a personal loan and a line of credit is, with a personal loan, you receive a fixed lump sum, but with a line of credit, you do not need to take out the entire amount immediately, and can withdraw any amount up to the limit.

With a line of credit, only the money withdrawn is charged interest, whereas a personal loan is charged interest on a regular basis until the entire loan is paid off.

People may choose to take out a line of credit if the amount of money they expect to use may vary. For example, if they are doing home renovations and the total cost may change, it could be beneficial to have a flexible amount of money to draw from when needed.

People may choose a personal loan for the consistency of regular payments and having an upfront amount for a specific purpose, such as a wedding.

Overdraft protection

- Overdraft occurs when you withdraw money from a bank account and the account balance goes below $0. This can be caused by activities such as cash withdrawals, pre-authorized debit payments or outgoing wire transfers.
- Overdraft protection is offered by banks for various bank accounts.
- Protection prevents the balance of the bank account from falling below $0, which stops non-sufficient funds (NSF) fees and overdraft fees from being charged.
- Overdraft protection is a pre-approved loan that begins when the bank account balance goes below $0.
- The application process is similar to other loan applications where factors such as your income and credit history are considered.

Small business loans

- Small business loans can help entrepreneurs reach their goals.
- Banks, the government or other companies or organizations such as CompanyCapital provide them.
- Generally, you will receive a lump sum amount of money and have to pay it back plus interest on a regular basis.
- The interest rate can be fixed or variable.
- To be approved for a small business loan, the lender will generally look at your personal credit score, collateral (business equipment, property) and time in the business or track record.
- There are several initiatives and programs available to assist Indigenous-owned businesses. Do your research!

Entrepreneurship resources from RBC

- Starting a Business: https://www.rbcroyalbank.com/business/advice/starting-a-business.html
- Business Banking: https://www.rbcroyalbank.com/business/index.html
- Outreach & Business Development for Indigenous Communities: https://www.rbc.com/indigenous/outreach-business-development.html

Part 4.3: Applying for credit

To apply for credit at a bank, visit their website or a branch location to learn more about their offerings and specific processes.

Examples of required information during the credit application process

- Identification: Government-issued photo ID
- Proof of residence: Rental or lease agreement, recent bill
- Employer information: Letter of employment, employment contract
- Income information and proof of income: Pay stubs, bank statements
- Credit report: From a credit reporting agency

Getting started with the credit card process

Getting a credit card can be the first step in building your credit history and can help when applying for mortgages or loans.

To get a credit card:

1. Choose the type of credit card that is best suited for you: bank issued, store/priority or travel/entertainment card.
2. Research which banks and other companies offer the type of card you want including its interest rate, fees and perks.
3. Apply for the credit card. This can be done online, by phone or in person.

Getting started with the mortgage process

A mortgage is a big commitment, so take your time completing these steps:

1. Save for a down payment: If you've received a large lump sum, this amount could go towards your down payment or to future mortgage payments.
2. You may need to build your credit history first so you have a good credit score when lenders view your credit report, since buying property is such a large purchase.
3. Research which banks and other companies offer mortgages, including their interest rates and terms.
4. Book an appointment with an advisor at your bank or the company you choose, either virtually or in person, to begin the application process.

Getting started with the personal loan process

Personal loans are also a big commitment, so take your time when completing the steps below:

1. Decide who you want to borrow from: Which bank or company has the interest rates and terms that work for you?
2. Decide how much money you want to borrow: For example, how much is the home renovation or wedding going to cost, and how much money can you afford to pay back every month along with interest?
3. Decide if you want the loan to be secured or unsecured.
4. Decide for how long you want to be paying back the loan. This will affect the term of the loan.
5. For bank loans, book an appointment with an advisor at your bank, either virtually or in person, to begin the application process. For other loan providers, book an appointment, visit their location or start the online process.

Part 4.4: Understanding debt

What is debt?

Debt is money that is owed. When you borrow money, you are taking on debt.

- **Good debt:** Debt you are able to pay off that positively affects your credit score.

  Example: A mortgage can be good debt because you are accumulating value in a home.

- **Bad debt:** More debt than you can pay off that, as a result, accumulates interest.

  Example: A pay-day loan can be bad debt because of the high cost of paying it back.

Savings and loans

Both savings and loans can help you reach your short-term and long-term goals. Here's a comparison of loan and savings options that can help you reach the same goal.

Goal	Savings are funds you set aside and add to over time.	Loans are funds you borrow and must pay off.
Pay for post-secondary school (tuition costs)	**Registered Education Savings Plan (RESP):** ▪ An investment plan created for a beneficiary's future education. ▪ The person who opens the RESP can contribute up to $50,000 in total, and the government will also contribute up to $7,200 in total. ▪ Tax on the growth of your RESP investments is deferred until the funds are withdrawn – typically when the beneficiary is ready for post-secondary education.	**Student loan:** ▪ Funds loaned to students to pay for their post-secondary education tuition that they must repay. ▪ There are options from the federal government, provincial government and banks.
Access funds for a larger purchase or goal	**Tax-Free Savings Account (TFSA):** ▪ A savings account where contributions are not deductible for income tax purposes. ▪ The interest, dividends or capital gains earned are tax-free. ▪ There is a yearly contribution limit, and if contributions exceed this limit, there are tax penalties. ▪ You must be 18 years old to open a TFSA.	**Line of credit:** ▪ A specified amount of money that a borrower can draw from and must pay back along with interest. ▪ Can be secured or unsecured. ▪ Has a flexible term (the length of time the line of credit is available for).

Savings options are discussed in depth in Part 5.

Managing debt

Tips for managing debt

- Borrow only what you need. Make sure you understand the interest fees that go with the money borrowed.
- Set up automatic payments for loans and credit cards so you won't miss a payment.
- Pay off debt that has the highest interest rates first.
- Be careful when choosing the type of loan and loan provider:
  - Consider the monthly payment obligations and whether these can realistically be paid.
  - Consider the timelines for the loan and how long it will take to repay it.
  - Compare rates, extra fees and charges.
  - Consider the knowledge and reputation of the provider.
  - Consider the customer service that will be provided if there are questions or concerns.
- RBC provides loan calculators to find out what your line of credit or loan payments would be.
  - Visit https://www.rbcroyalbank.com/personal-loans/loan-calculators.html to learn more.
- The Government of Canada also provides various financial tools and calculators that may help you in your decision-making: https://www.canada.ca/en/services/finance/tools.html.

Credit can help you reach many goals, such as the purchase of your dream car or home, and can fund positive experiences if it's used as intended.

Activity: Credit card quiz

Let's check your understanding of credit cards!

Please indicate whether the statements below are True or False:

		True	False
1.	The annual percentage rate (APR) is the total monthly cost of borrowing.	☐	☐
2.	Late credit card payments affect your credit score.	☐	☐
3.	To have a credit card, you must apply and get approved.	☐	☐
4.	Credit cards and debit cards are the same thing.	☐	☐
5.	You must be the age of majority (18 or 19 years old) in your province or territory to legally get a credit card of your own.	☐	☐
6.	A prepaid card is the same as a credit card.	☐	☐

Answers on the next page.

Answers

1. *False. The APR represents the total yearly cost of borrowing.*
2. *True.*
3. *True.*
4. *False. A credit card means you are borrowing money to spend, while a debit card means you are spending money you already have in your bank account.*
5. *True.*
6. *False. A prepaid card is not linked to a bank account and is a card that has been loaded with money in advance. A credit card means you are borrowing money to spend.*

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