Wealth Management

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The in and outs of credit

Understanding how credit works and differentiating between the types of credit that may be available

When it comes to borrowing money, there are a number of credit options available. Given the range of choices, it may sometimes be difficult to know which option to select or which is most appropriate for your financial circumstances.

What is credit?

Credit can generally be defined as a form of borrowing, and the ability of a customer to obtain goods or services before payment, based on the trust that the payment will be made in the future.

Two common terms that are associated with credit are "principal" and "interest."

- **Principal** = The amount of money borrowed
- **Interest** = The lender's charge for the risk of lending their money.

The rule of borrowing on credit

You must pay back the principal plus interest on the loan.

principal + interest

What is a credit score?

Your credit score is a number that indicates to lenders your capacity to repay a loan. The first time you borrow money, a credit rating report is created. Credit reports are maintained by credit reporting agencies, and they factor in a range of variables. The credit reporting agencies use the information from all of your credit reports to generate your unique number or score.

In Canada, credit scores range from 300 to 900, the latter of which is the highest number an individual can achieve.

In general, a score above 650 will likely qualify you for a standard loan while a score under 650 will likely bring difficulty in receiving new credit.

Options for borrowing

Specifically in Canada, three common borrowing options are:

- Credit cards
- Lines of credit
- Personal loans

Each option has its own features and characteristics, but one common element all three share is that there's a cost associated with each.

To find out more about credit or the RBC Wealth Management Financial Literacy program, please contact us today.

Credit card

A credit card is a beneficial option for building your credit score at an early age, if it's used properly. It is suited for uses such as smaller purchases and online shopping. In general, credit cards are meant for very short-term borrowing, and they allow you to borrow without interest until your statement's due date. After the due date, credit cards charge a high rate of interest starting from the date of your purchase.

With this form of credit, it's important to pay at least the minimum balance, or preferably all or as much of the balance as possible, each month. Missing even one minimum payment can negatively impact your credit score.

Line of credit

A line of credit is often considered the most flexible way of borrowing money, because a specific amount may be requested, but it doesn't need to be used all at once. In addition, it's possible to repay and re-borrow, and lines of credit generally tend to carry a low interest rate. When it comes to interest, in general, it needs to be paid monthly, which leaves you as the borrower with flexibility to make principal repayments when you have the cash.

While this option may offer relatively low costs and reasonable flexibility, keep in mind that it requires good financial discipline to make the repayments of the principal.

Personal loan

In situations where you need to borrow money for a larger item, such as buying a car, for example, this is where a personal loan may be a good option. Generally speaking, a personal loan will take longer than a year to pay back and the payments comprise a mix of principal and interest. This type of repayment helps ensure your loan is repaid in the time frame chosen when the amount was borrowed. With this form of loan, interest rates are generally considered to be relatively moderate.

Deciding which type of credit to use

In selecting the form of credit to use, your individual circumstances will dictate what choice makes the most sense. Additionally, three main factors to consider are:

- Your ability to repay
- The term
- The interest rate

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