Snapshots™

NEWCOMERS:
CREDIT IN CANADA

CAREFULLY APPLIED, THE USE OF CREDIT CAN HELP YOU GET THE THINGS YOU WANT FASTER – WHETHER IT IS A NEW HOME, A NEW CAR, STARTING A BUSINESS OR A UNIVERSITY EDUCATION.

But overuse of credit can leave you buried in debt. So using the many types of credit available to you through your bank – credit cards, loans, mortgages – should be part of a carefully considered plan. You want your purchases to enhance your life, not burden it.

Making smart use of credit

Credit is the ability to borrow money from another party, be it a friend, financial institution or another lending agency. As we noted above, there are many reasons why you may want to borrow money. But as useful as it is, credit must be used cautiously. After all, you have to repay that money in the agreed-upon time frame and make regular interest payments. If you fail to meet those obligations, it will have repercussions.

Credit history

When a borrower approaches a bank or another grantor of credit for a loan, the lender will want to know if the borrower has repaid past loans. To check his or her credit history, the lender will turn to Canada's two main credit-rating agencies, Equifax Canada and TransUnion Canada.

Equifax and TransUnion store and maintain individuals' credit information for use by their members, who in turn update the two agencies on their customers' credit and payment activities. Their members include banks, finance companies, auto leasing companies, credit card companies and retailers.

The two agencies apply a rating for each credit transaction based on how well the customer met his or her obligations to repay, and calculate an overall score that takes into account how quickly and how faithfully past debts have been repaid. Scores range from 400 to 900, with anything between 600 and 750 being "good" and anything over 750 being "excellent."

When a borrower goes to the bank for a car loan, for example, the bank will ask the credit-rating agency for a report, which includes the borrower's credit history, rating and score. (For more information, go to Understanding your credit report and credit score.)

As a newcomer to Canada, you are at a disadvantage. You won't have a credit history. So, you will have to establish one.

The easiest and most effective way to do this is to acquire a Canadian credit card (see below). Your bank will place certain restrictions on your account. You may, for example, have only a $1,000 limit – and you may need a co-signer to your agreement. The bank may even block a sum of money in your savings account to cover your credit card bill, should you fail to pay. But if you pay off your credit card in a timely fashion – and don't let balances accumulate from month to month – you will show that you have used the card responsibly. You are on your way to establishing a good credit rating.

Tapping the sources of credit

Credit cards

Credit cards are a convenient way of making purchases, but they can be very costly if you do not use them properly. Annual interest charges are high – in the 17%-20% range – and you are charged monthly on unpaid balances. Missed payments add up quickly and soon you are paying interest on top of interest. A credit card is not "free" money; you are really taking out a loan, a high-interest loan at that.

You can obtain a credit card through your bank or financial institution, but there are also several credit card companies that offer cards without the need for a bank account. It is important to pay attention to the "fine print" on the usage agreement with your credit card provider. Interest rates vary widely, as do credit limits, grace periods (length of time before interest is charged), benefits such as purchase protection and extended warranties, and whether you need to repay the balance in full each month. It pays to shop around to find the card that is right for you. And, although obtaining multiple cards can be easy, it is probably not a good idea. You can soon find yourself mired in high-interest, credit-card debt.

The government of Canada, through its Financial Consumer Agency of Canada, offers a lot of help to card users. For example, its interactive Credit Card Selector Tool can help you find the best card for your needs. The Credit Card Payment Calculator Tool lets you calculate how long it will take to pay off your credit card balance. Go to the FCAC website.

Loans

If you are planning a large purchase, such as a car or a home renovation, you may turn to your bank or financial institution to finance your expenditure. But remember, loans are an ongoing financial commitment. Before you take that step, give your financial situation serious consideration:

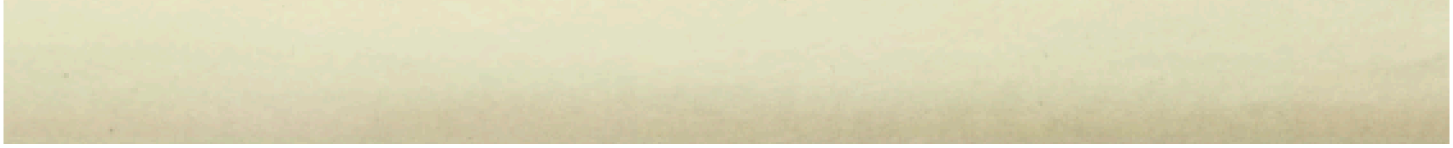
- Is your cash flow such that you can afford regular loan payments?
- How much can you afford to pay each month?
- What do you need to give up in order to afford your loan?

Loans come in various shapes and sizes. For example, you will probably have some choice as to the term of the loan or how long you will take to pay it back. You may be given the choice of a "fixed" rate of interest, meaning it doesn't change over the period of the loan, or a "variable" rate, which will change as interest rates change. That may be cheaper initially, but if interest rates go up, it will have a material effect on your loan payments.

Case Study: Purchasing a car

When Marlene's company offered her a promotion, Marlene (32) jumped at the chance, even though the job was in its Canadian operation. Her husband Peter (35) agreed to the move, knowing that his skills were transferable. Sure enough, six months after their arrival, Peter found a job in sales for an engineering company. Peter was enthusiastic about the new job but it meant the couple needed a car, a purchase they had been putting off. It was time to go car shopping.

Marlene and Peter agreed they needed a comfortable car with good safety features, as Peter would be travelling a lot. And they liked the idea of a new car with a good warranty. They had some cash available to make a down payment but figured if they bought a vehicle in the $25,500 range, they would need to finance the purchase, either through their bank or the auto dealer. They also considered the option of leasing their vehicle; monthly payments would be lower, helping the cash-flow situation.



Although they had owned a car before they came to Canada, Marlene and Peter were unfamiliar with the Canadian marketplace and prices. They started their research for a new vehicle online, reading car reviews and consumer reports. They picked out three cars at two manufacturers they thought were suitable and visited their showrooms. They also spoke to their bank representative to find out the cost of a bank loan. Finally, they spoke to their insurance advisor, so they understood how much car insurance would add to their monthly costs. For more information on insurance, see the Insurance section .

Here's what they found out:

- Car loan. You can obtain a car loan from your bank or from the auto dealer that sells you the car. You may get a loan for the entire amount or, if you make a down payment, for the difference remaining. The vehicle is the security for the loan. If you are borrowing from your bank, you can usually negotiate the terms of your loan – how long you take to repay it (anywhere from one to seven years), your payment schedule (monthly or bi-weekly, for example) and whether you pay a fixed or variable rate of interest. If you are borrowing from the auto dealer, the terms of the loan may not be as flexible.
- Car lease. When you lease a car, you are essentially renting it. You make regular payments for the term of the lease and, because you are paying only for the depreciated value of the vehicle over the term of the lease, those payments are lower than car loan payments. You generally have a mileage allowance – for example, 64,000 kilometres for a three-year lease – and anything over that you pay a fee, for example 10¢–15¢ per kilometre. At the end of the lease, you often have the option to purchase the vehicle for a predetermined amount. Or you can turn the vehicle in and start a new lease.

Marlene and Peter considered their options. If they took out a five-year loan, at the end of that period they would own their car. But they would be responsible for the costs of maintenance once their three-year warranty ran out. Also, if Marlene were offered another promotion and transfer, they would be stuck selling the car.

On the other hand, if they signed a three-year lease, the most attractive offer, at the end of three years, they would own nothing, both a plus and a minus. There was some concern that the 64,000-km. limit would not be enough, so Peter discussed the extent of his travelling with his employer. Perhaps, the selling feature, their monthly payments were considerably lower with the lease, which was attractive as they weren't sure about future plans.

Both options had tax consequences. Since Peter is using the car for business, his lease payments are an income-tax deduction, subject to Canada Revenue Agency rules. Likewise, if they borrowed to buy the vehicle, Peter could deduct the interest payments.

In the end, Peter and Marlene decided it was a lifestyle decision and leased their vehicle. They figured that in three years, when the lease expired, they would have a better sense of their future in Canada, if it would become a permanent home or a stepping stone in Marlene's career.

The decision to lease or borrow to own can be difficult and you should look very closely at the terms and conditions of each alternative to determine which is best for you.

Lines of credit

With a line of credit, your bank or financial institution pre-approves an amount it will lend you, allowing you to borrow as the need arises up to that limit without making a formal loan application. You may get an "unsecured" line of credit based on your credit worthiness or a "secured" line of credit, which is backed by collateral such as property or investments. The interest rate on a secured line of credit will be somewhat lower than the unsecured due to the collateral provided.

A line of credit can be very useful if you have ongoing but irregular needs for cash. You are charged interest on the amount withdrawn from the day you make the withdrawal until the loan is repaid; at a minimum, interest must be paid every month.

Mortgages

Owning a home is popular in Canada and, for most people, purchasing a home is the largest financial commitment they will ever make. For most people, that means holding a mortgage. So, if you decide to purchase a home, you are likely to go to your bank and take out a mortgage.

To get a mortgage in Canada, you must have enough cash saved to make a downpayment on the property you are purchasing. To get the most favourable mortgage rates, you need to be able to pay 20% of the buying price of the house; your lender will finance the other 80%, using the value of the home as collateral for the loan. For other options, go to Canada Mortgage and Housing Corp. at Housing for newcomers.

There are many aspects to a mortgage and a few of the features you should consider are:

- Amortization period. This is the total term of the mortgage, often 20 to 25 years.
- Term. This is the length of the current agreement. For example, a mortgage with a 25-year amortization period may have a term of five years, which is renegotiated every five years.
- Interest rate. The basic rate will be determined by the term of your mortgage and current market conditions. At the end of a five-year term, if rates are lower, your next five-year mortgage may have a lower rate – or vice versa.
- Prepayment options. You may be allowed to pre-pay some percentage of the mortgage once a year.

For an idea of how much mortgage you can afford, visit FCAC's website at Mortgage Calculator Tool.

Case Study: How the Gomezes used credit to build their new life

When Hector Gomez (32) was offered a great job in Canada, he and his wife, Inez (30), made the leap. They left Chile with their eight-year-old son, Carlos, and immigrated to Canada. The family settled in Burlington, Ont., and Hector, a civil engineer, took up a position as the assistant manager of South American projects at Jameson Partners (JP), a firm with both domestic and international operations.

JP provided a lot of support to the family; it helped them find a rental home and subsidized the cost. The couple did have some savings in Chile, which they transferred to Canada. But Hector and Inez knew in time they wanted to purchase a vehicle and own and furnish a home. They knew they would have to borrow money to fulfill those dreams – and to borrow they would need a credit history and rating.

So Hector and Inez did some research and put together a step-by-step plan to establish their credit rating.

Step One

Hector and Inez opened a savings account and a chequing account at the local branch of their bank and transferred their savings from Chile into the accounts. At the same time, they had an interview with a bank representative and discussed credit card options. The Gomezes chose a fairly basic card that had a manageable credit limit of $3,000.

The couple had never had a credit card before and carefully read the "fine print." They learned the importance of avoiding high-interest payments – 18% annual interest calculated monthly on unpaid balances – and the effect missing those payments could have on their credit rating. Each missed payment would be noted in their credit history and affect the calculation of their credit score.

Hector and Inez were more than a little surprised to realize that other financial institutions and department stores were happy to offer them additional credit cards – at even higher interest rates. However, they decided to keep their credit situation simple and manageable and forego the inducements and advantages these other cards promised.

Step Two

The Gomezes needed a vehicle. They found a good, three-year-old Subaru for $18,000. But rather than pay for the vehicle from their savings, they decided to take out a partial loan. Not only would they preserve their capital but faithful repayment of the loan would help them build a positive credit rating. So, Hector and Inez paid $10,000 from their savings and borrowed $8,000 from their bank. Since they had no credit history, Inez's uncle Luis, a 10-year resident of Canada, co-signed the one-year loan. At a 4.5% interest rate, the loan added $196.33 to the cost of the vehicle, but the couple thought it was worth it if it helped them meet their goal of establishing a credit history.

Hector and Inez added the $683.02 monthly car loan payments and the $190 monthly car insurance payments to their monthly budget of expenditures. For the next year, they carefully used their credit card and faithfully paid their monthly balances as they came due. In fact, the bank offered to increase the limit on their credit card. But they politely declined, feeling that they weren't quite ready for additional credit. They also paid off their car loan.

Step Three

Two years after their arrival in Canada, Hector and Inez had established a credit history and had a favourable score. And it was paying off for them. Shortly after they repaid their car loan, Inez found a job. The Gomezes decided it was time to buy a home of their own. They found a three-bedroom, semi-detached home in a convenient location near good schools. The $500,000 price tag was reasonable and with a little help from their parents in Chile – who were looking forward to visits – they tapped the rest of their savings and made a $100,000 downpayment. They turned to their bank to mortgage the remaining $400,000.

When they approached their bank to negotiate a mortgage, they were very pleased to find that their credit rating was near the top of the scale. The mortgage was granted at a very attractive rate of 3%. They amortized the mortgage over 25 years and took a five-year term with an annual prepayment option of 10% of the mortgage.

Using the Mortgage Calculator Tool on Financial Consumer Agency of Canada, Hector and Inez calculated their options. They had considered monthly payments but then their bank representative suggested they consider weekly mortgage payments and making an annual prepayment. The advantage of the prepayment is the amount goes directly to pay down principal. Here's how the two options compared:

	Monthly, no prepayment	Weekly with prepayment
Number of payments	60	260
Mortgage payment	1,893	437
Annual prepayment	0	2,000
Principal payment	58,102	69,029
Interest payment	55,477	54,477
Total cost	**113,579**	**123,506**

Over the five-year term, the Gomezes reduced their principal considerably more by making weekly payments and prepayments, with little additional outlay. But the real payoff came at the end of the amortization period. By making annual prepayments, they saved $22,416 in interest and paid their mortgage off 35 months sooner than if they had the same mortgage with no prepayment. The weekly payment schedule shaved another $365 off the interest payments.

Hector and Inez are pleased with how their financial situation has developed since coming to Canada. They have a home, a car and a credit card, should they need it for special occasions. They have money available to save for their son Carlos's education and they are talking to their financial advisor about saving for retirement. They feel their responsible use of credit is improving their quality of life.

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