What Are Credit Limits?

Description

Credit limits are exactly how they sound: a curb on how much you can charge to a credit card at one time. Though they're pretty simple to understand, they do come with some rules cardholders should be aware of. To help you use your limits responsibly, here's what you should know.

What are credit limits?

Credit limits are the maximum amount you can borrow on a credit card. Your card issuer provides these limits when you apply for your card, and you can't exceed them without being penalized.

Keep in mind: credit limits are different than your *available credit.* As you use your card, your card issuer will subtract purchases from your credit limits. The resulting amount is your available credit. When you make payments on your account, your available credit goes back up. If you pay the full balance, you'll be able to borrow at your full credit limits again.

How are credit limits determined?

Credit card providers determine limits by looking at your entire financial picture.

For example, your provider might look at your history with credit and loans, the current level of debt, employment status, and income. They'll see if you've recently applied for other credit cards, which could indicate financial hardship, and they'll check to see if you've filed bankruptcy or missed credit card payments in the past.

Typically, if you have a high score (660 or above is considered good), you'll get higher limits. Conversely, with a low score or little or no credit history, card issuers aren't convinced they can trust you with high limits. Until you can demonstrate that you can pay back what you borrow, you'll probably have lower credit limits.

Since credit limits are based on your personal history with credit, you won't know your card's limits until your application is accepted. And, yes, you *can* dispute them. If you think you deserve higher credit limits, you can contact your lender and present your case. There's no guarantee they'll raise your limits, but it's worth a try if you have a strong argument.

What if you have *really* bad credit?

If you have bad credit, you may not be able to secure credit limits on a traditional card. But you still have options.

One is to take out a secured credit card. With a secured credit card, you put down an initial deposit, and if you miss a payment, your credit card provider will use the deposit to pay off your account balance. The credit limits on a secured card are usually equal to the initial deposit, though sometimes they can be double. A secured card can help you rebuild your credit score, and eventually, your score may be high enough for you to take out a non-secured card with higher limits.

Should you max out your credit limits?

Though your credit card provider might extend thousands, even tens of thousands, of dollars to you, that doesn't mean you should max out your card every month.

For one, you could hurt your credit score. A large portion of your score — about 30% — measures how much credit you're using versus how much you could potentially borrow, or what's called your credit utilization ratio. For instance, if you borrow $4,000 on a card with a $10,000 limit, your ratio would be 40%. Borrowing more than $4,000 would raise the ratio, and eventually, you'll see your credit score drop.

In general, it's best to keep your credit utilization ratio below 30%. Anything above that could start to hurt your score.

Additionally, maxing out your credit card could make it harder for you to get out of debt. You may think you'll pay off a maxed-out credit card by the end of the month. But if an unexpected expense derails your budget, you could end up carrying a balance. This, in turn, will trigger interest rate charges, making it more difficult for you to get out of debt.

That's why it's best to use only a small portion of your credit limits. You'll be in a stronger position to pay your balance in full each month, and you won't risk damaging your credit score.

What happens if you exceed your credit limits?

First off, your card issuer may not *let* you exceed your limits. When you sign up for a credit card, you're typically given the option of opting in for "over-the-limit" transactions. If you don't opt-in, your card will simply be declined if a purchase puts you over your limits.

If you opt-in, however, you'll pay an "over-the-limit" fee when you go above your credit limits. The fee ranges from $25 to $30, and you're typically charged one over-the-limit fee per billing cycle.

Your card provider may alert you when you're close to your limits. But they're not obligated to do so. Typically, it's your responsibility to stay within your limits and to stop yourself from using your card when you're close to surpassing them.

Can credit card providers change your limits?

Yes. Your credit card provider can absolutely change your credit card limits. If you pay your bills on time, and if you don't max out your card every month, your lender could naturally raise your credit limits. If this happens, consider it a compliment. Your lender sees that you're a responsible borrower, and as a reward, they let your borrow more money.

Alternatively, you could request an increase. Your credit card provider will typically look at your income, employment, mortgage (or rent), and debt levels to decide if you can take on more credit. If you can demonstrate that you're a responsible borrower, you shouldn't have a problem extending your credit limits.

Of course, credit card providers can also *lower* your limits. Your lender may not feel comfortable with the high amount that you're borrowing every month. Or, you may do something that makes you seem riskier, such as miss a payment or exceeds your limits too many times.

How do credit limits impact your credit score?

Credit limits can help your credit score if you use them responsibly. In general, it doesn't matter how high or low your limits are. What matters is how much of the limits you use.

It all goes back to your credit utilization ratio. As long as you can keep this ratio below 30%, it doesn't matter if your limits are $6,000 or $60,000. You'll be in good standing with credit bureaus. Borrowing over 30%, however, can start to have an adverse effect, and you'll typically notice a major drop if you start charging over 50% on a regular basis.

Requesting a credit limit increase can also have a negative impact on your score. When you request an increase, credit card companies will typically run a hard inquiry on your credit. Hard inquiries can lower your score by a few points, though fortunately, it won't cause long-lasting damage. Unless multiple lenders run hard inquiries on your credit within a short period of time, you probably won't see a major drop in your score.

Foolish bottom line

Credit limits are the spending parameters on a credit card, and no matter how high they are, you should aim to use no more than 30% of them at one time. The best credit cards in Canada will let you opt-out of "over-the-limit" transactions, stopping you from incurring penalties for exceeding limits, though you should always keep an eye on your spending, as carrying a high balance can be just as costly as going over your credit limits.

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