What Is a Credit Card?

Description

A credit card is a piece of plastic that allows you to borrow money to buy things. When used with a budget, a credit card gives you the luxury of buying something now and paying for it later, while also offering you a slew of rewards, perks, and credit-building power.

But let's not hide the obvious: credit cards have a dark side. They give extended buying power, and if that power falls in the wrong hands, things can get ugly quickly. Good credit usage comes down to self-control and personal responsibility, but it also comes down to knowledge. The more you understand how credit cards work, the more you can prepare yourself to combat the risks and disadvantages of credit cards.

So, let's go back to square one: what is a credit card, how does it work, and how can you use it to your advantage? Below, we're going to break it down.

What is a credit card?

A credit card allows you to borrow money from a financial institution in order to make cashless purchases. Every credit card comes with a maximum credit limit that you cannot exceed (doing so could result in penalties). You borrow money against this credit limit under the agreement that you'll pay it back before your billing cycle ends.

Credit cards are a revolving line of credit. Unlike a loan, which expires after you pay it back, a credit card allows you to borrow funds, pay them back, then borrow them again. The more money you borrow, the less credit you have available. And the more credit you pay back, the more you can borrow again.

Credit cards come with a vocabulary of their own, and if you're not familiar with some key terms, you can easily get confused. Here are a few important terms you should know.

Annual fee

An annual fee is simply a yearly charge that cardholders pay to use certain credit cards. Cards with annual fees typically have higher rewards, or they're designed for those who have bad credit.

Annual percentage rate

Your card's annual percentage rate, or APR, is the interest you pay to carry a balance on your card. Since it's an annual rate, your card provider will break your APR into a daily rate, which they'll charge to an outstanding balance. If you pay your statement balance in full every month, you won't have to worry about ARP.

Available credit

Your available credit is simply what you have left to borrow. To calculate it, you simply subtract your current balance by your credit limits. While it's a little tough to say what the average credit limit in Canada is, the Bank of Canada has estimated that around 41% of Canadians have a limit of $10,000 or more.

Billing cycle

A billing cycle is the length of time, usually 28 to 31 days, between billings. At the end of your billing cycle, your card provider will compile all credits and purchases into a statement, and you'll be given a deadline to pay off the balance. Whatever you don't pay off will move forward into the next billing cycle.

Credit limit

Your card's credit limit is the maximum amount you can charge. If you charge more than your credit limits, your transaction will be denied, or you'll pay an over-limit fee.

Current balance

The current balance is the total unpaid charges to a credit card account. The current balance is different from a *statement* balance, which tells you how much you need to pay off before your billing statement's due date.

Grace period

When your billing cycle ends, you'll receive a billing statement, which tells you your statement balance (the amount you need to pay off) as well as a due date. The time between the end of your billing cycle and the due date is a *grace period.* During the grace period, you don't accumulate interest (APR) on unpaid charges. As long as you pay your statement balance before the due date, you won't pay *any* interest. But if you don't pay the full balance before the due date, your grace period disappears, and you'll pay interest on unpaid charges.

Minimum payment

When you get a billing statement, you'll also see a minimum payment amount — usually a percentage of your unpaid balance or a flat rate. This is the absolute minimum you must pay to avoid late fees and damage to your credit score. Of course, if you only pay the minimum, you'll carry a balance, which triggers APR charges.

Statement balance

The statement balance is all the charges that have "posted" (that is, not pending) on your account before your billing cycle ends. This is different than your *current* balance, which tells you the total amount you have charged to your card, regardless of billing cycles. For example, let's say your billing cycle ends on July 15. Let's also say you charged $500 before July 15 and $150 on July 18. In this case, your statement balance would be $500 and your current balance, $650.

How do credit cards work?

Now that you understand common credit card terms, let's put it all together and see how they work.

Let's say you take out a credit card with a credit limit of $5,000 and an APR of 20%. Your billing cycle starts on June 15 and ends on July 15. During your billing cycle, you charge $1,535, but you also pay $500. At midnight on July 15, your card provider closes the billing cycle and sends you a billing statement, which includes your statement balance ($1,035) and a due date (August 6). You're also given a minimum payment: $35.

The minimum is an important threshold. If you don't pay the $35, things will get ugly. For one, you'll pay a late fee as well as trigger a penalty APR — one that can be significantly higher than your card's normal APR. If you don't pay the minimum within 30 days of your statement's due date (in this case, September 5), your card provider will report the late payment to credit bureaus, which will likely damage your credit score.

But let's say you do pay the minimum — and *only* the minimum. The due date (August 6) passes, and you leave $1,000 unpaid on your account. Because you're now carrying a balance into the next billing cycle, your grace period ends. Now you're going to pay interest on the $1,000. You'll pay all the interest that accumulated between July 15 and August 6, and you'll pay a daily interest rate for every day after August 6 that you don't pay the full $1,000.

If, however, you pay your full balance before August 6, your grace period extends in the next billing cycle. You don't pay APR charges, and your credit limits recharge by the amount you paid.

What are the different types of credit cards?

Though all credit cards work in a similar way, they don't all come with the same features and benefits. Some are designed to help you build or rebuild credit, while others help you earn rewards and points. As you're scanning the best credit cards of Canada, you'll come across four main types of credit cards:

rewards, cash-back, secured, and balance-transfer cards.

1. Rewards credit cards

Rewards cards are the credit cards that get people most excited, simply because they can help you earn *money.* With a rewards card, you'll earn points or miles on eligible purchases, and after you've accumulated a fair amount, you can redeem them for cash, gift cards, or a credit to your account balance.

Of course, rewards cards have their differences, too. Some are designed specifically for travel, while others are designed to be used in specific stores, such as **Loblaw** or Discount Tire. Whether travel or store card, however, most rewards cards will give you points or miles for every purchase you make, along with higher points for certain purchases, such as food, gas, and entertainment.

Likewise, how you redeem those points or miles can impact how much they're actually worth. For example, your card provider may give you $.007 per point when you choose to credit your account balance. However, when you convert those same points to purchase certain goods or airfare, you may get $.02 or even $.04 per point.

2. Cash-back credit cards

A cash-back card is a type of rewards card, sure. But because its reward system works differently than points and miles, it's easier to analyze it separately.

Here's how cash-back cards work. Your card will come with an earn rate, usually expressed as a percentage. This earn rate tells you how much cash you'll earn for each purchase. For instance, if you card has a 2% earn rate, then you'll earn $2 for every $100 you spend.

It gets better. Many cash-back cards give you a higher earn rate for certain purchases, such as food, entertainment, and travel. So, you might have a card with a 5% earn rate on food, 3% on travel, and 1% on everything else. Not bad, right? If you match a cash-back card with your spending habits, you could earn a *lot* of money.

3. Secured credit cards

Rewards and cash-back cards sound great. But what if you have bad credit? What if you made mistakes in the past, but you'd like to fix them? Is there a credit card for you?

With a secured credit card, you put down an initial deposit before you can use your card. This deposit, usually equal to or double your credit limits, acts as collateral. If you miss a payment, your card provider will use the deposit to repay what you borrowed.

Because a secured credit card is linked to an initial deposit, credit card companies are more willing to issue them to Canadians with bad credit. Over time, as you pay back what you borrow, you'll rebuild your credit score. Boost your credit score enough, and you might be able to graduate to a better card, like a rewards or cash-back card.

4. Balance-transfer credit cards

A balance transfer allows you to move debt from one account to another — typically one with more favourable terms. A balance-transfer *credit card* is simply a card that receives the balance transfer — a feature that not all credit cards offer.

Balance-transfer cards often come with a low introductory APR, often significantly lower than the average APR on a credit card. If you're carrying a high balance on a card with a nasty APR, a balance transfer card could help you save a lot of money in interest charges.

But you have to be strategic. A balance transfer's low APR doesn't last forever. It typically lasts anywhere from a few months to a year. If you can pay off your high balance within the low APR period, you're a rock star. If you can't, your credit card company will start charging a regular APR, which could put you in the same position as before.

How are credit cards different than debit cards?

Like a credit card, a debit card is a piece of plastic that allows you to make cashless purchases. But beyond that simple definition, debit and credit cards couldn't be more different.

First off, a debit card is attached to your bank account, whereas a credit card is tied to a revolving line of credit. When you make purchases with a debit card, your bank transfers funds directly from your chequing or savings account. Unlike a credit card, you're not borrowing money. You're spending money that's already in your account.

Because a debit card isn't attached to a revolving line of credit, it doesn't impact your credit score one bit. You can use your debit card all your like, but your spending activities won't be reported to crediting bureaus.

Finally, a debit card rarely comes with rewards and perks like a credit card. They also offer less fraud protection. Most card providers won't hold you responsible for fraudulent activities made on your card. But debit cards work differently. You typically have to report fraud to your bank within a specific period of time to get reimbursed. What's worse — if a fraudster has your debit card, they have direct access to your money. When it's gone, it's gone, and it's up to your bank to give it back.

What are the risks of credit cards?

Any time you borrow money, you take on certain risks, and credit cards are no different. Because they come with high interest rates and fees, credit cards are notorious for putting people into uncontrollable debt as well as wrecking credit scores. Below are just a few of the most common credit card dangers.

1. Borrowing more than you can pay back

Perhaps the biggest credit card risk is the temptation to overspend. A credit card extends your buying power, which could lead you to think you have more money than you truly have.

When you charge more than you can pay back, you'll end up carrying a balance on your card. Making the minimum payment gives you a false of security, as you think you're making progress. Meanwhile, you're accumulating high interest charges, which make it harder for you to get out of debt.

2. Missing payments

Accumulating interest on unpaid balances is a hefty risk. But missing payments? That's even more risky business. A late or missed payment will result in a late fee. On top of that, your card's APR will spike to a new rate. If you're over 30 days late, your card provider will report the missed or late payment to credit card bureaus, damaging your credit score.

3. Damaging your credit score

Finally, abusing your credit card can have a negative impact on your credit score. For one, if you miss or delay a payment, you'll damage your payment history — a whopping 35% of your credit score. Not only that, but if you max out your card or carry a high balance, you'll raise your credit utilization ratio, which measures how much credit you've borrow versus your total credit limit. Since this makes up 30% of your credit score, maxing out your card can easily lower your score by double digits.

How should you use a credit card?

You may have heard horror stories of people going into debt because of credit cards. Yes, if you don't use your credit card right, that could definitely happen. But it doesn't happen to everyone. When you're responsible with your card, you'll enjoy the benefits without risking your financial health. To use your card wisely, here are some habits you should establish.

1. Only charge what you can afford

This is credit card usage 101: don't borrow what you can't repay. In theory, it's uber-simple. In practice, however, it can be tough to maintain.

Perhaps the best way to follow this is to use your card in tandem with a detailed budget. With a detailed budget, you give every dollar you earn a name and purpose. Your credit card is simply a way to buy what you've already budgeted for. You have the money — ideally, it's already in your bank — and if the purchase exceeds your budget, don't buy it. Period.

If you're afraid of abusing your credit card, you could use it for small purchases, such as movie or music subscriptions. This ensures you're always using the credit card (helping you build a credit score), while also preventing you from overspending.

2. Always pay your balance in full

Credit cards are super easy to maintain when you pay your balance in full and on time each month. But the moment you start carrying a balance, things get complicated (and expensive) fast.

Though, yes, your credit card provider will require you to only pay the minimum, you're smarter than that. By paying only the minimum, you're giving your provider your hard-earned cash to cover interest charges. It's basically an investment in reverse: the more you charge to your credit card, and the longer you carry a balance, the more you'll dish out to your credit card provider.

To avoid this hassle, pay your balance in full. Charge only what you can truly afford, and you'll be in a good position to pay off your credit card each month.

3. Stay *far* below your credit limits

Every credit card comes with credit limits, sure. But if you charge too much (or worse, max out your card), you'll put yourself in a tight spot.

For one, the more you charge to a card, the harder it is to pay off your full balance. It's easy to pay off $200. But $5,000? That's mighty feat for the average consumer.

Maxing out your card also hurts your credit-utilization ratio, which makes up a whopping 30% of your credit score. Basically, credit card companies use this ratio to measure how much credit you've used versus the total amount of credit you've been given. For instance, let's say you've been given $5,000 in credit. If you charge $1,000, you credit utilization ratio will be 20% ($5,000/$1,000). But if you charge $2,500, your ratio jumps to 50%, which is high.

If you want to help your credit score, it's best to keep your credit-utilization ratio below 30%. Anything above 30% will start to have a negative impact on your score.

4. Know your benefits and rewards

If your credit card has a rewards program, by all means, use it! You should be aware of which purchases, if any, will earn you more points or cash back, as well as figure out the most advantageous way to spend your rewards.

Similarly, do some research into the perks that are built into your credit card. For instance, most credit cards come with travel and rental car insurance, which you activate simply by using the card for airfare or rental car purchases. If you're not aware of these perks, you may end up buying unnecessary insurance or extended warranties, both of which can be ridiculously expensive.

Finally, if you're using your credit card for a balance transfer, make sure you plan effectively to take advantage of the introductory low APR period. The low APR phase will typically last a few months to a year. If you're trying to pay down high credit card debt, you should aim to pay most or all of it during this phase, as you'll save a lot of money in interest.

5. Review your credit card statement

Finally, make a habit of reviewing the charges on your statements. If you don't recognize a charge, even if it's a small amount, notify your credit card provider immediately. Fraudsters like to charge a small amount just to "test the waters," then make a much larger purchase later. To avoid this kind of fraud from happening on your card, let your credit card provider know you don't recognize a charge, and they'll investigate.

Should you take out a credit card?

If you use your credit card responsibly, it will benefit you tremendously. As you borrow money and pay it back, you'll build a solid credit score, which will help you with home buying, renting, and even buying car insurance. Credit cards are accepted virtually everywhere, helping you make cashless purchases, and the fraud security ensures you won't lose a lot of money if a fraudster steals your credit card number.

Credit cards do have risks, but the degree to which they harm you depends entirely on how you use your card. At the worst, you'll fail to pay the minimum on your statement, forcing you to pay late fees and APR, or even damaging your credit score.

Fortunately, Canadians have plenty of great credit card options. Whether you want to build credit or earn rewards, you should have no problem finding a credit card that's right for you.

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