What Is a Secured Credit Card?

Description

If you have bad credit, a credit card can help you rebuild your score. But to even *get* a credit card, you need a good credit score. So how are you supposed to repair your credit score if you can't get a credit card in the first place? Seems a little unfair, right?

There are indeed ways to build credit without a credit card. However, fortunately, there *is* a way to build a poor credit score with a credit card, and it's typically pretty straightforward. It's called a *secured* credit card. These cards are easy to get approved for, making them a potential second chance for Canadians who want to remedy their past.

What exactly is a secured credit card, how does it work, and should you take one out? Let's take a closer look and see.

What is a secured credit card?

A secured credit card is any card that's backed by a security deposit. Much like you secure a mortgage to your house, you secure your credit card to a sum of money, usually equal to your card's credit limits. If you default on your credit card, your provider will use the security deposit to cover your outstanding balance. Because of this built-in protection, secured credit cards are far less risky to card providers than traditional ones, which makes them easier to get no matter what your credit score.

How do they work?

The only difference between a secured credit card and a traditional one is the initial deposit. When you get approved for your credit card, you'll hand over a lump sum, usually equal to or double your desired credit limits. For example, if you want a card with a $1,000 limit, you might need to first give your card provider $1,000 to activate the card.

Your credit card provider will hold on to this money and use it if you default on your card. Occasionally, they'll put your deposit in a savings account or guaranteed investment certificate (GIC), which may help you earn some interest.

The initial deposit is refundable. If you build a strong payment history, your provider may give the deposit back and issue you an unsecured card. Alternatively, you could close your credit card account, and as long as you've paid your outstanding balance, they'll return your security deposit.

Aside from the initial deposit, a secured credit card works just like a regular credit card. You'll have credit limits, which you cannot exceed, and billing statements with your purchases packaged into one bill. Your secured credit card may come with a grace period, during which you won't pay interest on charges, as well as a due date, after which you'll pay interest on any outstanding balances.

If you miss a payment, you'll most likely pay a late fee. Miss too many payments and your card provider will use your initial deposit to cover the balance.

Is a secured credit card the same as a prepaid card?

No. They're *very* different. With a prepaid card, you load and reload your credit card with your own funds, which effectively takes the lender out of the picture. Because you're not borrowing money, you're not improving your credit score.

If you're looking for a cashless form of payment, a prepaid card could be right for you. For those who want to boost their credit scores, however, a secured credit card is a much better alternative.

How can a secured credit card help your credit score?

A secured credit card can be an excellent way to improve your credit score. As long as your credit card provider reports your activities to credit bureaus (they should), you may be able to boost your score and graduate to a better card. Here are three ways to maximize your secured card's credit potential.

In some cases, secured credit card issuers will provide you access to your credit score so you can keep track of your progress. But there are also ways to check your credit score for free.

1. Pay your balance off each month

At the very least, pay the minimum payment on your billing statement. This ensures you don't miss a payment, which would otherwise hurt your credit score.

But don't stop at the minimum. To give your score the extra *oomph* it needs, make a habit of paying your entire statement balance each month. When you pay your statement balance, you avoid paying interest charges, which can drag you down.

Given that the APR on a secured credit card tends to be higher than a traditional one, these interest charges can add up fast. Pay your bill in full and on time, however, and you'll never pay a dime of interest.

2. Keep your credit limits low

Look, we get it: the credit limits on secured credit cards aren't always the highest, and you could easily find yourself maxing out your card in a short period.

But, if you can help it, use your card for small purchases (and definitely ones you can afford). At the very least, try not to exceed 30% of your credit limits. For a card with a credit limit of $1,000, that means borrowing no more than $300 at any given time.

The reason is that excessive borrowing can raise your credit utilization ratio (30% of your credit score), which measures how much credit you're using versus how much total credit you can potentially borrow.

So, if you have $2,000, and you borrow $1,000, your utilization ratio would be 50%. In the eyes of crediting bureaus, 50% is high.

As you're rebuilding your credit score, keep this ratio as low as possible. Use your card for purchases you know you can pay back instantly, such as gas or music subscriptions. Pay back what you borrow and you'll likely start to see an improvement in your score.

3. Use your card for a long period

Finally, don't expect your credit score to improve after only one billing cycle. In order to truly impact your score, you'll have to work at it — and you'll have to work at it for months, even years. As long as you pay your statement balance in full and on time, as well as keep your utilization ratio low, you'll put yourself on the road to a good credit score.

Can a secured credit card hurt your credit score?

A secured credit card is still a credit card. And as such, it can hurt your score if you abuse it.

Perhaps the easiest way to damage your credit score is to miss payments. While, yes, your credit card provider can credit your account with your security deposit, they may still report missed payments to credit bureaus. Secured card or not, that can severely impair your ability to build your credit score in the future.

Can you use your initial deposit to pay your card balance?

No, you can't. You must pay the minimum or statement balance with money that's not held as collateral. If you can't make payments on time, you'll pay a penalty fee. Your APR may also jump to a penalty APR, which is often much higher than the traditional interest rate.

Miss too many payments and your credit card provider will use your deposit to credit your account. They may also choose to close your account, especially if you have a history of late payments.

How to choose the best-secured credit card

Canada has a fairly large market of secured credit cards, each with its own benefits and drawbacks. So, you'll definitely want to take your time and shop for the best-secured card for you. Below are just three key benefits to look for as your compare cards.

1. No or low fees

If you don't want to pay extra fees to build or rebuild your credit score, then look for a secured credit card with no annual fees. Pay attention to pesky hidden fees, too, such as application or start-up fees.

Sometimes, you can't help but take out a secured card with an annual fee, if those are the ones that will approve your application. If that's the case, look for a card that offers benefits in exchange for the fee. For instance, some secured credit cards will offer you a lower APR or valuable tools (such as credit utilization monitoring), while others will simply charge you a lower annual fee than others.

If you do end up paying a fee for your secured card, be extremely diligent in your credit-rebuilding efforts, so that you can quickly graduate to a card without the fee.

2. Ability to upgrade

Think of your secured card as simply the workout before the marathon: eventually, you want to build such a strong credit score, you can move on to better opportunities. Nobody wants to stay in the gym forever, right? At a certain point, you want to get on track.

As you're shopping around, then, confirm that your credit card provider will allow you to graduate to another card if you prove that you're a responsible borrower. If your card provider automatically upgrades the card for you, you won't have to go through the application process again.

3. Credit reporting

Finally, be sure your credit card provider *actually* reports your activities to credit bureaus. They should, but double-check to be sure. After all, if you're trying to rebuild your credit score with a secured card, you won't get very far if your card provider doesn't tell crediting bureaus about all the good borrowing you've been doing.

Is a secured credit card right for you?

Secured credit cards are a great idea if you're looking to build a credit score from scratch or repair a broken one. Alternatively, a secured card could be right for you if you want to improve your credit score but you don't want to risk defaulting.

The security deposit ensures you always have a backup plan to "exit" out of an outstanding balance, though be careful: forcing the card provider to use your deposit may hurt your credit score.

If you’re ready to build or rebuild your credit, you can start by comparing the best-secured credit cards in Canada. Look at the annual fees, credit limits, perks, and ability to graduate to a better card.

Once you find the right one for you, use your card responsibly, and, after a long period of good borrowing, you’ll be able to move up to a more lucrative card, such as a cashback or rewards credit card.

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