Consumers and Credit Cards: Aiming for a Level Playing Field

The current economic recession and the collapse of credit markets that precipitated it have given both consumers and governments reason to take a closer look both at how credit is used on an individual and family level and at the rules governing the provision and administration of credit, particularly credit cards. As a result of that kind of review, the federal government has come out with a series of regulatory measures designed, in its words, to “ensure that consumers have access to credit on terms that are fair and transparent”.

The new regulations focus on two areas: the first relates to disclosure by credit card issuers to consumers of information with respect to their cost of borrowing, interest rates charged, and the length of time that it will take consumers who are making only the minimum payment to actually pay off their balance, while the second area of change deals with how interest is calculated, how payments are allocated, and how and when credit card limits may be increased.

The two major changes in the areas of interest and payment calculation and allocation that are likely to have the biggest impact on the cost of borrowing for consumers are as follows:

Requirement for minimum 21-day grace period

Most credit card users know that, once they make a purchase using their card, there is an interest-free “grace period”, and if the amount representing the purchase is paid before the end of that grace period (known as the due date), no interest is charged. What many consumers don’t realize, however, is that where a balance is carried over from the previous month, and a new purchase is made, then interest may be charged not just on the balance carried forward but on the new purchase, even if the full amount is paid by the due date – in other words, there is no grace period for new purchases where an existing balance is carried over from the previous month. The new regulations would require credit card issuers to provide a minimum 21-day grace period on all new purchases, whether or not there is an existing balance on the card.

To explain how the new rules would apply, the Department of Finance provided the following example in its Backgrounder on the changes.

Tom pays his monthly balance in full as a rule. In April, he paid part of his balance during the course of the billing period, but he missed the deadline to pay the remaining balance, and carried a balance of $300 into May. On May 5, Tom made a new purchase of $50. He paid his outstanding balance of $350 in full by the due date shown on his statement (June 19). Here's how the existing two different grace-period methods would affect him.

If Tom’s credit card issuer uses Method 1, he will have to pay interest only on the $300 carried over from April. He will get an interest-free period on his new purchase of $50, because he paid his balance in full by the due date of June 19.

If Tom’s credit card issuer uses Method 2, he will have to pay interest on the $300 carried over from April and on the new purchase of $50, because he carried a balance over from April.

The regulations will ensure that all credit card issuers use Method 1 for the application of grace periods.

Allocation of payments in favour of the consumer

It is common for credit card issuers to apply different interest rates to different amounts on the same card, depending on whether the amount owed relates to a new purchase, a cash advance, or a balance transfer. Under the current practice, where a consumer makes a payment on the card, that payment is often applied to the amount with the lowest interest rate. The new regulations, however, will require that payments made in excess of the minimum payment required be allocated in the way that most benefits consumers. Two different allocation methods will be permitted under the new rules, and once again, the Department of Finance explained those allocation methods through the use of an example:

Christian obtained a credit card and transferred a balance of $1,000 with an interest rate of 2%. He made $600 in purchases with his new card at an interest rate of 15%. When he receives his statement at the end of the month, he makes a payment of $800.

Under the new rules, the card issuer can either allocate the $800 first to the balance with the highest interest rate, i.e. purchases, and the remaining amount to the balance transfer or, alternatively, it can allocate the $800 proportionally, i.e. $300 for purchases and $500 for the balance transfer. In both cases, this will lead to lower interest charges for Christian.

Finally, when a credit card is issued by a financial institution, it comes with a credit limit, which sets out the maximum amount that a consumer can charge to the card. However, it has been the practice of many institutions, particularly where the balance on the card is near or at that limit, to increase the limit. The unfortunate reality is that too many consumers have found themselves further in debt than they ever thought possible, as they continued to take advantage of an ever-increasing limit on their card or cards. However, such automatic credit limit increases will no longer be permitted. Where a card issuer wants to increase the limit on a card already held by an individual, it must now obtain the express consent of that person. Specifically, the issuer must either contact the consumer directly or include a message about the proposed increase in the monthly card statement. In either case, it would be up to the cardholder to contact the credit card company to confirm that the credit limit increase was desired. If that express consent is not given, then the credit card limit cannot be increased.

These proposed new regulations are outlined in a press release issued by the Department of Finance, which can be found on the Department's Web site at http://www.fin.gc.ca/n08/09-048-eng.asp, and further details are provided in the Backgrounder to the release, which is available at http://www.fin.gc.ca/n08/data/09-048_1-eng.asp.