Why your line of credit may be more dangerous than a credit card

By Gail Johnson | Pay Day – Mon, 3 Feb, 2014 3:42 PM EST

Want to do renovations? Go on a big vacation? Have an elaborate wedding? Buy a new car? Maybe pick up a new computer or some better furniture? Those are all reasons that financial institutions have used to incite people to sign up for a line of credit (LOC). Yet money experts say that credit lines can be just as bad as credit cards when it comes to racking up excess debt.

"They are definitely a source of trouble," says fee-only certified financial planner Sheila Walkington, CFO of Women's Financial Learning Centre and Money Coaches Canada, adding they're just as dangerous as your credit cards.

"The ads say 'use it for a warm holiday or a new truck or that thing you deserve,'" she adds. "It's too easy for some people, especially when it's at a low interest rate. People will say 'maybe we *should* do renovations now' or 'maybe we *should* buy the car now'. But they need to be clear that it's not their money and they have to pay it back."

Credit lines do come with lower interest rates than most credit cards. As soon as you repay any of the credit that's been used, it immediately becomes available to access again.

More and more Canadians, it seems, are turning to their credit line, with balances increasing across the country, according to a report last year issued by Equifax.
But LOCs are the "worst thing" that's happened to Canadians in the last 20 years, according to David Chilton, author of The Wealthy Barber and The Wealthy Barber Returns.

"If I was prime minister, I'd shut them down," Chilton said at a 2011 conference of the Canadian Pension & Benefits Institute as reported in the National Post newspaper. "It's unbelievable how people are abusing these things."

The right way to use a line of credit ... if you have a plan
Credit lines do have their place; some people use them to pay off higher-interest debts. That can be an effective strategy, financial advisor Stephanie Holmes-Winton says, provided there's a debt-repayment plan in place.

"Structure your line of credit to pay as much to it as possible, which is something that can be automated, so that you reduce your interest with every dollar you pay down," says Holmes-Winton, president and CEO of the Money Finder. "Start with a written cash-flow plan. Watch your statements. Look at your total debt every month."

Some use LOCs as their emergency fund. But there are still caveats.

“As an emergency fund, the goal is to keep it available for an emergency. An emergency is not defined by a trip to Thailand or a big sale on mattresses,” Walkington says. “We’re talking illness, job loss, the roof caving in -- that kind of stuff.”

It’s common for people to borrow money from a LOC to put toward RRSP contributions, Walkington says. Again, this is only a worthwhile strategy if there’s a plan in place to pay that money back, possibly using the ensuing tax refund. She urges people to do the math to see if this kind of short-term borrowing makes sense.

She also advises people who are tempted to use their credit line for nonessential purchases to ensure it’s not attached to their main chequing account.

“For some people, it just becomes a big overdraft,” Walkington says. “It’s like free money to them. To counter that, take the line of credit off the chequing account so it’s not that easy to access.

“If you don’t trust yourself, don’t have debit on it, make sure you have to write a cheque [to access funds], or maybe ask your spouse about it,” she adds. “Use it responsibly, because it does have to be paid back in a reasonable time. It’s easy to get carried away.”