

Credit can be a valuable addition to your financial toolbox if you use it carefully and sensibly. Credit means someone is willing to loan you money—called principal—in exchange for your promise to repay it, usually with interest. Interest is the amount you pay to use someone else’s money. So the higher the interest rate, the higher the total amount you pay to buy something on credit.

The best part about credit is that it lets you buy something - like a car or a year of college tuition - you couldn’t otherwise afford if you had to pay for it all at once. You get to buy the item now but pay for it over a period of time, usually with interest.

But sometimes people use credit purely for convenience. They have the money but don’t want to carry cash with them. Or they simply decide they want something NOW, don’t care if they have the money, and use credit for immediate satisfaction, which isn’t a smart use.

Credit: The Good and the Bad

Before you can decide whether credit is a good choice for you, it’s important to know all the rewards and risks of using it.

On the rewards side, credit offers:

Convenience. It’s often easier and safer to have a credit card or get a loan rather than carry around a large amount of cash. And it’s much more convenient to use a credit card for travel expenses and buying items on the Internet.

Protection. Buying items with a credit card can make it easier to get a refund if there’s a problem with an item you purchased. Also, some cards offer buyer protection - a type of insurance for items you buy with a credit card in the event you find them damaged after purchase. This protection also may apply to items mistakenly charged to your account.

Emergencies. With a credit card, you always have a way to pay for emergency expenses. If your car breaks down on a Sunday morning, you’re going to get back on the road much faster if you charge the repairs than if you try to find a nearby bank from which to get money.

Opportunity to Build Credit. Using credit responsibly is simply the best way to build your credit history. It makes it easier to get more credit when you need it later.

Quicker Gratification. Credit allows you to buy and use an expensive item, such as a car or house, while you’re paying for it instead of postponing your purchase until you have enough saved. For many people, it’s the only way they can afford to own a house or car.

Special Offers. Sometimes you can take advantage of special offers, such as a reduced interest rate for a limited time, or even deals to buy now and make no payments until next year. These offers decrease the short-term costs of using credit. (But always know when and what happens when the deals expire.)

Bonuses. Some types of credit also offer bonus points such as frequent-flyer miles or cash rebates for every dollar you spend. But credit card holders often pay for these perks through higher interest rates or annual fees. Savvy credit users carefully read the card's terms and weigh the value of the bonus features against potentially higher costs.

So now you've heard all the great things about using credit, let's consider the potential risks:

Interest. As you learned earlier, interest is the amount you pay for using credit. This automatically makes the item more expensive than if you had just paid for it with cash.

Overspending. People often use credit to live beyond their means - buying items they simply can't afford. As time goes on and the amount they owe grows, it gets harder and harder to pay down the balance.

Debt. The amounts you borrow add up to what is called your **debt**, or the entire amount of money you owe to lenders. These lenders have legal claims against your future income should you not be able to repay a debt. And if you take on too much debt, it can completely derail your financial plan - and your future.

Identity Theft. Identity theft occurs when someone uses your personal information without your permission to commit fraud or other crimes. Each time you give out your credit card or Social Security number, you're at risk for someone stealing that information to run up debts in your name.

Building a Good Credit History Just Takes Discipline

- Always pay your bills on time. That's the single best way you can show creditors that you'll be responsible with their money.
- If you have a savings account, it's good to make additional regular deposits, no matter how small. Lenders like to see a consistent savings pattern.
- Be choosy about your credit cards and loans. Apply only for the ones you really need, and keep them for a long time.
- Surprisingly, it's better for your credit score to maintain a low balance on one card and pay it off each month than to have no balance at all.

Ways You Can Hurt Your Credit History and Credit Score:

- Making late payments. Even just one missed payment can affect your credit report.
- Writing checks when you don't have enough money in your account to cover them. (This is often called "bouncing" checks.)
- Having a lot of credit cards and loans. If lenders think you have too much credit available to you, they may perceive you as a risky customer.
- Maintaining high balances on your credit cards and loans. Especially with credit cards, lenders are leery of lending you more money if your balances are too close to your credit limit.
- Changing credit cards frequently. Lenders like to see credit card holders maintain long-term relationships with credit card companies. Your score may decrease a little if you're always switching to cards with a good introductory offer.

The Titans of Credit

There are three main credit reporting agencies in the United States: Equifax, Experian, and TransUnion. By law, people are entitled to a free copy of their credit report from each of these companies once every 12 months. It is against federal law for anyone to obtain another person's credit report without that person's permission. The most popular credit score is the FICO score. The score ranges from about 300 to 850, with the higher score reflecting a lower risk for the lender. In general, a credit score of 680 or above is considered good.

Does it Really Matter What My Credit Score is?

It matters a lot. Of course, the worst-case scenario when you have a bad credit score is not getting approved to borrow the money you need, not being able to rent an apartment, or not getting a job. Yes, people with bad credit can still get approved sometimes - but they pay a lot more for the privilege. People with low credit scores usually have to make higher down payments or pay higher interest rates. And remember, on big-ticket items, even 1 percent more in interest can have a huge effect on your budgeted fixed expenses. Think of good credit as another important reserve to have. Just as it's good to have savings for unexpected expenses, a good credit score means you can always borrow money if the need arises.