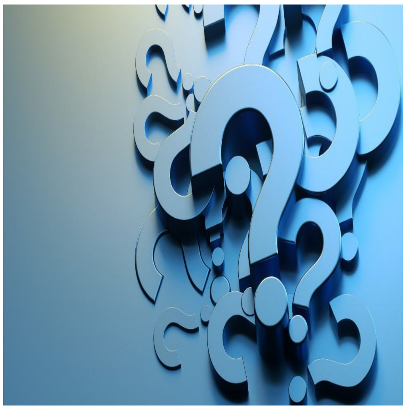

Are Credit Cards Good or Bad?

Description

You've probably heard the horror stories. Someone takes out a credit card. They think they're a responsible spender, but a few years on—and one too many shopping sprees later—that person is overwhelmed with debt.

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On the other hand, you may have heard stories of people earning rewards, building credit scores, and managing expenses with credit cards. So confident are these people with their cards that they may even pay an annual fee to hold one.

So which is it? Are credit cards good or bad? Well, the truth is, credit cards aren't themselves good or bad. They're not a slippery slope that automatically puts you into debt. And they're not an investment that earns you money. Rather, they're a financial *tool.* Depending on how you use them, credit cards can be helpful or they can be harmful.

So when do they help you and when do they hurt? Let's take a closer look at credit cards and see.

When a credit card is helpful

Credit cards are helpful when you use them responsibly. If you pay back what you charge and don't charge too much per month, a credit card has multiple advantages over cash. Here are just five ways credit cards can help you get ahead.

1. Credit cards help you build a credit score

Perhaps no other financial tool can help you build or rebuild a credit score more effectively than a credit card. When you charge purchases and pay them back in full and on time, credit card companies will report good crediting activities to major credit bureaus.

The longer you have a credit card and the more you pay bills on time, the better your credit score will become.

Note that there are ways to build credit without a credit card, but doing so with a credit card can often be a bit easier and more straightforward.

Tip

You can see The Motley Fool's top credit card picks by visiting our comparison of the best credit cards in Canada.

2. Credit cards help you earn cashback and rewards

Rewards credit cards and cashback cards both offer you the opportunity to earn money while you spend. It doesn't get much better than that, right?

With these rewards cards, you'll earn points, travel miles, or cash back for eligible purchases. Many rewards cards will offer a higher earn rate for certain spending categories, such as groceries, gas, and entertainment. Other cards operate on a rotating benefits system, offering you higher rewards for categories that change every quarter.

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If you match a credit card's spending rewards with your spending habits—say, a credit card with higher rewards for grocery purchases if you budget more for food—you can find yourself earning cashback at a surprising (and exciting) rate.

Along with the card's reward program, many cards come with sign-up bonuses. These bonuses can help you amass an enormous amount of rewards in a short period of time. For instance, you may get an offer to earn 20,000 travel miles if you spend $1,000 on your credit card in the first three months. That's a good offer, especially if you normally earn 1.5 miles for every dollar you spend (at that rate, you'd have to spend $13,334 to earn 20,000 miles).

3. They have fraud protection

In addition to helping you build a credit score and earning cashback rewards, credit cards have another leg up on debit cards: they protect you instantly from fraudulent activities.

Credit card companies take fraud very seriously. Most companies monitor your crediting activities and will alert you immediately if a suspicious purchase is made. For instance, if you live in Ottawa, but someone uses your credit card to buy a kayak in Ohio, your credit card company will report this to you. Unless you have an American cousin who you've authorized to go nuts on Lake Erie, you can dispute the charge.

Even if credit card companies don't detect fraudulent activities, but *you* do, you will be typically be reimbursed, no matter when the fraud happened. Often your credit card company will reimburse the full amount. At most, you'll pay $50 of the unauthorized transaction, an amount set by the Canadian government.

What about debit cards?

Debit cards may offer fraud protection, too. But you usually have to report suspicious activities immediately or within a set amount of days to get any amount of reimbursement. After those days pass, you may be out of luck.

What's worse is that, with a debit card, fraudsters have direct access to your money. Once they've stolen it, it's gone, and it's up to your financial institution to replace it. With credit cards, your money isn't stolen. It's the credit card company whose money is stolen. The card issuer must fight the fraudster to get their money back, while your money sits safely in your bank account.

4. They're nearly universally accepted

No matter where you go in the world, you'll almost always find numerous ATMs, retailers, and local businesses that accept major credit cards. While cash is accepted, too (in the appropriate foreign currency), a credit card prevents you from carrying wads of cash in theft-prone areas.

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5. They have extra insurance and purchase protection

If you thought earning rewards was good, get ready for this. Most credit cards come with built-in insurance and purchase protection, both of which can save you money if you find yourself in a tight spot. Examples of these include:

- **Travel insurance:** trip cancellation/interruption coverage, extra medical insurance, baggage coverage, rental car insurance, and roadside assistance are all common coverages for globetrotting cardholders.
- **Extended warranties:** credit card companies will often extend a product's warranty to help you replace it if it becomes defective after the manufacture's warranty ends.
- **Purchase protection:** if you buy an item, only to discover later that it's broken or defective, your credit card company may reimburse the purchase. Similarly, if you bought an item online and it gets lost or stolen en route, you may get a refund.

When a credit card is harmful

Let's face it: for as much as credit cards can help you build credit and earn rewards, they do come with risks. Below are just a few ways credit cards can work against you.

1. You miss credit card payments

Missing a credit card payment is no joke. For one, if you fail to make your payment within 30 days, your credit card company will report the missed payment to credit bureaus. Considering that payment history makes up a significant chunk of your credit score (35%), missing even one payment can drop your score by a significant amount.

A missed payment also triggers your card's penalty APR. This APR could be higher than your card's normal interest rate, and it'll be charged to your outstanding debt for every day you fail to pay it back.

2. You carry a balance on your card

All credit cards come with a grace period, usually 21 to 25 days. During the grace period, you won't pay interest on your charges. But there's a catch: in order to enjoy the grace period's interest-free shelter, you must pay your credit card balance in full each month. If you don't, you'll get slapped with interest charges for outstanding balances.

Interest on credit cards can be dangerously high, often an annual rate of 20% to 30%. If you find yourself struggling to pay off your credit card balance, these interest charges will only drag you down.

You do have options, however. You might be able to negotiate a better interest rate with your lender. If not, you could take out a balance transfer card. These cards typically come with an introductory low APR, helping you pay less in interest. If you can pay down the debt before the low APR period ends, you can potentially save a lot of money.

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3. You max out your card limits

Every credit card comes with credit limits. But that doesn't mean you should spend up to the limit. Doing so could quickly put you in a sticky situation, especially if you can't pay off what you borrowed.

Aside from putting your finances in a bad position, maxing out your credit card can also raise your credit utilization ratio. This ratio, which makes up 30% of your credit score, measures how much debt you owe versus how much you could potentially borrow. For instance, let's say you owe $6,000 on your credit card. If your credit limit is $10,000, then your credit utilization ratio would be 60%.

The higher your utilization ratio, the lower your credit score will typically fall. In general, you should aim to take out no more than 30% of your available credit (and pay it back before your billing cycle ends). When you take out more than 30%, it will likely start to have an impact on your score.

Is a credit card right for you?

The question of whether a credit card is good or bad is really a question of whether *you* are good or bad with borrowing money.

For those who feel a credit card will tempt them to overspend, a credit card may not be a smart option. Missing payments, carrying balances, or even defaulting can seriously damage your financial health and credit score. In that case, you'll probably be better off using cash or a debit card.

But for those who pay back what they borrow, a credit card can offer you more luxuries and rewards that no debit card could even dream of offering. For you, it's not a matter of whether credit cards are good or bad. It’s a matter of which credit card is the best for you. And once you answer that, you’ll fortify your budget and earn even more rewards in the long run.

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