Good Credit

Why is Having Good Credit Important?

Many people in the United States have financial problems. They have poor credit, are in debt, have little savings or have a combination of all three. One or more of these issues can put you in a financial crisis. Poor credit is a real issue for many Americans.

Good credit can help you in many ways. It can help you make large purchases, such as cars and homes. It can help establish you as a responsible person. For example, potential employers might review your credit history when making a hiring decision.

Poor credit can give lenders a reason to charge you a higher interest rate, costing you more money.

A bad credit rating can cost the average person $750 a month — which is $9,000 per year or $750,000 over a lifetime — because of extra fees and charges resulting from a low credit score. Excessive interest, higher insurance rates, and lower-paying jobs are just a few of the hardships faced by people with credit problems.

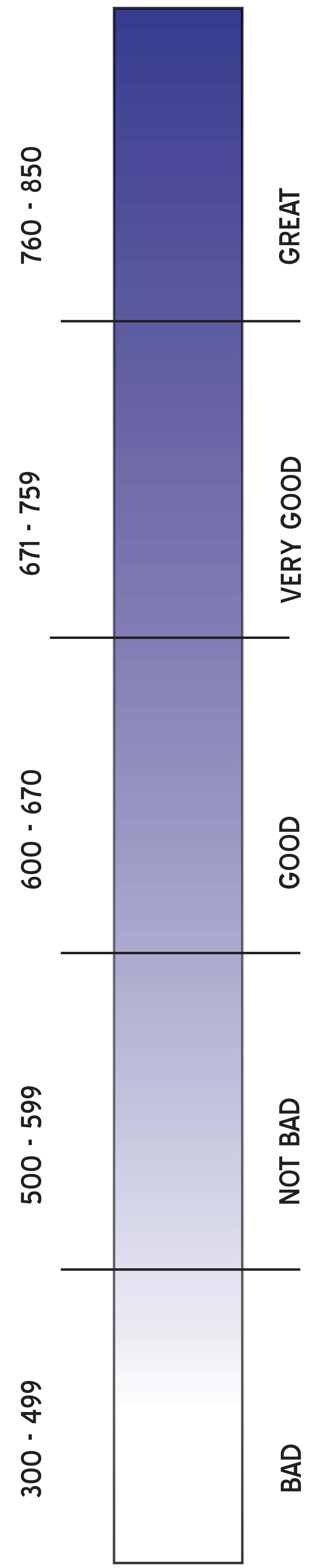
How is My Credit Score Calculated?

FICO score (named for the Fair Isaac Corporation) is a way of measuring your creditworthiness without looking at your income history or employment status. It is used by major credit reporting agencies. Credit card providers and banks use your FICO score to determine credit limits and interest rates. The standard method for calculating a FICO score uses the following factors:

- Punctuality of paying your bills (35%). Do you pay bills early or late?
- Ratio of debt being used divided by total available credit (30%). How much credit you use vs. how much credit you can get?
- Length of payment history (15%). How long have you had a particular mortgage or credit card?
- Ratio of installment (mortgage) divided by revolving debt (credit cards) (10%). How many monthly payments you have vs. how much credit card debt you have?
- Recent credit applications, credit checks (10%). How often have you applied for credit in the recent past?

Credit scores differ depending on who is doing the calculations. Ask your lender to see how they calculate your actual credit score.

FICO Scores



Activity: Estimate Martin's Credit

Use the following facts to estimate Martin's credit score:

- This year he paid his mortgage late twice.
- Last year he paid his credit card bill late twice.
- He has had the same credit card for the last nine years.
- He now rarely uses his credit cards, except his gas credit card.
- Two years ago, his ex-wife spent beyond the maximum limit on a credit card issued in both their names.
- Last year he paid off and canceled that card.
- He has a low balance on one of his two remaining credit cards, and $2,000 on the other.
- He has a mortgage that he has been paying for the last year.

What do you think Martin's credit score is?

a. Great.
b. Very Good.
c. Good.
d. Not Bad.
e. Bad.

Answer:

C or D– Not Bad to Good. Martin does have some positive financial behaviors, especially in the past year. He has paid down one credit card to a zero balance and has low balances which help his ratio of debt use. Currently he has $2,000 of debt, which he is paying off regularly. He has had the same credit card for nine years, and a mortgage for one year, which helps his length of payment calculation. Martin has never filed for bankruptcy or been to court over financial issues. He now only has two credit cards, one with a low balance.

What has hurt Martin's credit score are his late payments: those two missed mortgage and credit card payments. Also, at one time his ratio of debt was also very high because of the one credit card's balance being over the credit limit.

The good news is that if Martin continues to make his payments regularly and carries low balances, he will have a very good credit score in a few years.

Credit Card Basics

The greatest cause of bad credit is the misuse of credit cards. It helps to understand how they work.

IMPORTANT INFORMATION

When you look at your credit card bill, look for the following basic information:

- **Annual Percentage Rate (APR):** The cost of credit as indicated by a yearly interest rate. This rate must be disclosed to you before you get your card. Take a look at your current bill. It will be in a table labeled “Finance Charge Summary” or “Interest Charge Calculation.”

- **Outstanding balance:** The amount remaining to be paid. Look for how the credit card company determines the outstanding balance on which you are charged interest for the billing period.

- **Finance charge:** The cost of credit for the billing cycle. This is a dollar amount determined by multiplying the outstanding balance by the periodic interest rate.

- **Fees:** Other fees, not including the finance charge. This includes annual fees, cash advance fees, balance transfer fees, late payment fees, and over-the-limit fees.

- **Grace period:** The time during which you are allowed to pay your credit card bill without having to pay interest.

BEWARE OF CREDIT CARD TRAPS

- **Changing interest rates**
Credit card companies sometimes offer low introductory “teaser” rates to attract new customers. These rates generally last for a few months and then jump as high as 20 percent. Compare offers from several companies before selecting a card.

- **Balance transfers**
If you are not using your credit card, but want to minimize the finance charge on your outstanding balance, you might transfer your balance to a new card with a lower "teaser" interest rate. If you do, be cautious! Read the small print: the low introductory rate may change.

- **Other details to watch for include:**
  - A low interest rate on new purchases but a higher interest rate on balance transfers.
  - A low introductory interest rate that applies only for a short period of time.
  - Balance transfer fees, particularly amounts calculated as a percentage of the balance transferred.
  - Termination fees and retroactive interest charged if you transfer the balance again and close the account or transfer the balance to another card before a specified time period has passed.

Avoiding Credit and Credit Card Problems

Here are a few rules to follow to avoid trouble and keep good credit.

Check off those that you are NOT doing now!

☐ **1. Pay your bills and loans on time; avoid late fees and penalties.**
It is better to pay before the due date. For example, mortgage payments are typically due the first of each month, and late fees are charged on the 15th. However, waiting to pay until the end of the grace period will negatively affect a credit score. If you consistently pay bills before the due date, your credit score improves.

☐ **2. Pay off credit card balances in full each month.**
If you cannot pay off your credit card balances in full, at least pay more than the minimum payment.

☐ **3. Restrict credit card use if you can't pay the monthly minimum.**
If you cannot pay the credit card's monthly minimum, limit that card's use.

☐ **4. Avoid cash advances**.
Do not use credit cards for cash advances. The interest rates are usually much higher, and there is no grace period. Interest starts building the day you take the advance.

☐ **5. Charging within credit limits**.
"Maxing out" your credit card is a mistake. Fees and interest will be added to the limit and push you past the limit, resulting in more fees.

☐ **6. Review statements regularly and carefully.**
Review your credit card statements, or check activity online and often. If you don't recognize an item, call the credit card company and ask for more information on the charge. There is a lot of credit card fraud taking place these days. Waiting too long to question charges may make it hard to clear up problems.

☐ **7. Keep a list of all credit cards.**
Keep a list of all your credit card and bank account numbers, along with contact information for each. Keep them ready so you can report a lost or stolen credit card or checkbook. Do it immediately upon discovering that either is missing.

☐ **8. Avoid legal disputes over money.**
Other things that negatively affect your credit score are collections, tax liens, court judgments and bankruptcies. These can stay on your credit report for years, even if you pay them off. However, most of your credit score is based on activity in the past 24 months.

☐ **9. Pay on time.**
Send your credit card payment several days in advance of the due date to allow for mailing or online transaction time. Late penalties are costly, and some companies will increase the interest rate after one or two late payments.

☐ **10. Stick with one or two cards.**
It is easier to manage paying one or two credit card bills at the end of the month. Although it is tempting to apply for credit cards at department stores when they offer discounts, remember that 10 percent of your credit score is based on how often you apply for credit. On the other hand, an unused credit card with a zero balance will improve your ratio of debt calculation.

Analysis:

Avoiding Trouble: If you checked only ONE of boxes 3, 6, 7, or 10 you are probably OK. However, you need to try to follow these rules to avoid future problems.

Heading for Trouble: If you checked box 4 or 5, you may be heading for trouble. Avoid using your credit cards and review your spending habits to reduce spending. A visit with a consumer credit counselor (see Resources) is a good idea.

In Trouble: If you checked ANY of boxes 1, 8 or 9, you probably need to see a consumer credit or financial counselor to help you improve your credit score. See Resources for more information.

Wrapping Up

Take the following quiz to better understand what you do and do not know about the basics of credit and credit cards.

1. How many credit cards should you have to get the best credit score?

a. Five or more.
b. Three or four.
c. Just two.
d. Just one.
e. None of the above – the balance carried on each card has a greater effect on your credit score.

2. What are the two main factors used to calculate your credit score?

a. Number of credit cards and punctuality of paying bills.
b. How long you have had your credit cards and number of cards.
c. Length of payment history and punctuality of paying bills.
d. Credit used vs. credit available and punctuality of paying bills.
e. Credit used vs. credit available and length of credit history.

3. What is a grace period?

a. The time period during which you may pay your credit card bill without paying interest.
b. The time period during which you may pay off your account without legal consequences.
c. The time period during which you may pay your minimum monthly balance.
d. The time period before you can be charged interest for an item.
e. The time period after your monthly bill is paid before a finance charge is added.

4. What is considered a good credit risk or a high credit score?

a. 710 or higher.
b. 760 or higher.
c. 570 or higher.
d. 620 or higher.
e. 550 or higher.

5. What needs to be considered most before making a balance transfer of credit card debt?

a. The introductory rate.
b. The introductory rate and any changes to the rate.
c. The maximum credit limit.
d. The current deal between credit cards.
e. Others who have used that card.

6. What is a finance charge?

a. The introductory interest rate only.
b. The maximum credit limit.
c. The cost of credit for the billing cycle.
d. The fees for late payments.
e. The application fee.

7. What are typical extra fees that can be charged on a credit card?

a. Credit investigation fees, application fees, processing fees and over-the-limit fees.
b. Cash advance fees, application fees, processing fees and over-the-limit fees.
c. Legal processing fees, balance transfer fees, late payment fees and over-the-limit fees.
d. Legal processing fees, balance transfer fees, credit investigation fees and over-the-limit fees.
e. Cash advance fees, balance transfer fees, late payment fees and over-the-limit fees.

8. What is APR?

a. Annuity Percentage Rate (APR): The cost of credit to be paid for a minimum balance.
b. Annual Percentage Rate (APR): The cost of credit as indicated by a yearly interest rate.

c. Adjusted Percentage Rate (APR): The decreased cost of credit for balanced paid.
d. Average Percentage Rate (APR): The average cost of credit for your average balance.
e. Acquired Percentage Rate (APR): The cost of credit benefits provided for payments received.

9. What will happen if your credit card balance is near the card's maximum limit?
a. Other credit card companies will be notified that you are approaching your limit.
b. You will get charged limit fees if you are within $100 of your limit.
c. The interest will be included in the balance, which may put you over the limit.
d. You will not be able to make purchases two months after reaching the limit.
e. You will be put on a list tracked by consumer credit bureaus.

10. What is an outstanding balance?
a. The amount paid last cycle.
b. The amount due this cycle.
c. The amount remaining to be paid.
d. The amount projected to be paid by spending patterns.
e. The maximum balance carried in the last year.

Resources

To get more information on credit and credit counseling, refer to the following:

- **CREDIT SCORE:** You can order your free annual credit report online at www.annualcreditreport.com, by calling 877-322-8228, or by completing an Annual Report Request Form and mailing it to Annual Credit Report Request Service, P.O. Box 105281, Atlanta, GA 30348-5281.
- **CREDIT COUNSELING:** Your local Consumer Credit Counseling Service may be helpful in advising you on how to manage your credit. For the nearest agency, call 1-800-388-2227.

Key: 1) E 2) D 3) A 4) B 5) B 6) C 7) E 8) B 9) C 10) C

Notes