

Credit Scores

THE COMPLETE BEGINNER GUIDE



**Credit Scores:
The Complete Beginner Guide**

PersonalProfitability.com

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Your credit score is one of the most important numbers you will ever have in your life. It is like your old GPA (grade point average) from school, except for your money. Banks, credit card companies, lenders, employers, and landlords all use your credit score to decide if you get a new account, loan, apartment, or even a job. At the same time, it can save you tens of thousands of dollars on a mortgage loan. Here is everything you need to build an excellent credit score, and how you can understand and use it.

Start with Your Free Credit Score

A lot of people think you can only get a free credit report, not free credit score. WRONG! I have been using [Credit Sesame](#) for years to get my credit score 100% free. You can try it out for free today too! It only takes a few minutes to get your score on [Credit Sesame](#) with free advice on improving it. Credit Sesame gives you a free score update once a month.

Benefits of Credit Sesame

The key benefits are clear:

1. See a complete picture of your overall financial health
2. Learn how the terms of your loans and credit cards compare to your peers and the market
3. Find personalized advice and see recommended products to help improve your credit

[Sign up for Credit Sesame Here](#)

You can also get a free credit score from [Quizzle](#), with a more detailed credit report and analysis. I like the details I get from Quizzle, but they only give you a free update twice a year. Because of this, I have a [Quizzle](#) account as well and suggest one to any of you. After all, it is free and gives you more data to improve your credit score.

Benefits of Quizzle

1. Get your credit score and credit report for free
2. See details on what factors are influencing your score clearly
3. Link to other important financial metrics like home value and mortgage

[Sign up for Quizzle here](#)

Once you have your free credit score, continue on and compare your score to the information below to map out a strategy to improve (or maintain) your credit score.

Another option for a free credit score is [Credit Karma](#). I used to use this site more than any other, but my use of the site has declined over time and I now primarily use Credit Sesame and Credit Karma.

Why Does My Credit Score Matter?

In your day-to-day life, your credit score doesn't matter much. It matters when you need to get new credit, like a loan or credit card.

Your credit score will help underwriters determine whether you are credit worthy for a new loan or line of credit. It will also impact your interest rate. Better scores help people qualify for the best interest rates available.

If you want a new mortgage loan, for example, your credit score may tell a bank that you don't qualify at all. If you do, you may be able to save tens of thousands of dollars, or more, in interest depending on your score.

What is a Credit Score?

A credit score is a number between 300 and 850 that tells a lender if you have been responsible with past credit. An "excellent" score is generally a score that starts around 720-740 and above. Between 680-720 you are considered to have a "good" score. 620-680 is an "average" score. Below that, you have either a low, bad, or poor score and will have trouble getting new loans or credit.



The credit score is also called a FICO score, named for the **Fair Issac Corporation**, the company that developed the credit scoring system. Your score is generally reported by one of three credit bureaus, TransUnion, Equifax, or Experian.

In the long run, your credit score is a tool that you can use to accomplish your goals. Use your credit accounts to optimize your financial life. You don't need an 850 credit score to get the best rates, you only need a score in the "excellent" category. Optimize your accounts to increase your score if you are in the market for any type of new credit or loan, such as a mortgage or car loan. Once you have those taken care of, it is okay if your score drops a little. I signed up for a new travel reward credit card, which lowered my score, but [helped me get free flights](#). That is worth it if you will not be getting any new loans in the near future.

What Goes Into My Credit Score?



Payment History – 35% of credit score

The single most important factor in your credit score is making on-time payments. If you pay any credit account late, the bank can report it to a credit agency. I wouldn't suggest playing with fire, but most do not report a payment as late until 30 days.

After that, your account will certainly show your late payment. Being 30 days, 60 days, or 90+ days late on a credit or loan payment will have a big impact on your credit score. Be smart and pay on time.

Collections, public records, foreclosures, and bankruptcies impact this portion of your score calculation.

Outstanding Debt – 30% of credit score

We all have credit cards. (If you don't, [you really should have at least one.](#)) We don't all carry balances. How much debt is sitting on your credit cards, or any revolving debt, has the second biggest impact on your credit.

To calculate this portion of your credit score, the credit agencies calculate your **credit utilization ratio**. To calculate your ratio, add up the limit of *all* of your credit cards. If you have 3 cards with a limit of \$5,000, \$7,000, and \$1,500, your total limit is \$13,500. Next, add up your total balance on all of your *revolving credit* accounts (don't include installment loans like a car loan, student loan, or mortgage). If you have balances of \$500, \$200, and \$0 on those three accounts, your total balance in \$700.

Last, divide your total balance by your total limit to calculate the utilization percentage. In this example, your credit utilization ratio would be 5%. The lower your number, the better your credit score. Over 20-25%, your score will suffer and you will have a tough time getting new credit.

Keeping a small balance to raise your score ***IS A MYTH***. Having a utilization of 0% is the best way to keep a high credit score.

Length of Credit History – 15% of credit score

The average length of time your credit accounts is open makes up 15% of your score. Take the total number of months *all* accounts have been open and divide by the number of accounts to find your average. This calculation includes all accounts closed within the last seven years, so closing accounts quickly will lower your credit score.

My average age of credit is currently 3 years and 5 months. Having an average age of credit over 8 years is ideal, but difficult for young people.

New Credit – 10% of credit score

Applying for new credit gives you a “hard hit” on your credit report. Getting new credit both lowers your average age of credit and increases your new credit. That will lower your score.

If you are in the market for a new home or car loan in the near future, avoid all new credit to ensure your score does not suffer.

Credit Mix – 10% of credit score

When I got my mortgage loan in 2011, my credit score went up more than ten points! Why? Because I added a loan that indicates a stable and responsible borrower. If you only have credit cards, you are considered a riskier borrower than someone with installment loans as well.

Adding a car loan does not help you a whole lot, but adding a conforming mortgage can help bump up your score a lot. Of course, that doesn't mean you should buy a house to help your credit, your credit should help when you [decide to buy a house](#).

Where Credit Score Information Comes From: Your Credit Report



All of this data comes from your credit report. While the exact formula is a secret, you can look at your credit report (again, free from [Quizzle](#) or [AnnualCreditReport.com](#)).

Even if you don't think you will ever need credit in the future, it is always a good idea to ensure your credit report is accurate and shows your ability to responsibly use and manage credit. Having a good credit score can save you a ton of money when applying for loans, and can save you having to put down a service deposit on phone or internet service. Most importantly, it can be used when you are applying for a job, and no credit history can raise as many questions and flags as a bad one.

What Information is in Your Credit Report

Your credit report is made up of all of the information around your current and past credit and loan accounts, with some age limits on older closed accounts. Every credit account you have open, and the entire payment history from those accounts, is included on your credit report. You can also find information on bankruptcies, collections, public records, and inquiries made over the last two years when you applied for new credit.

Some people believe that checking account overdrafts, your age, and your salary can be included in your credit report. None of those will ever be on your credit report, as your credit report only contains information related to credit accounts and indicators that demonstrate a positive or negative borrowing history.

How Can I Fix My Bad Credit Score?

YES! You can make your score better. To increase your score, I suggest closing all of your revolving credit accounts with negative information and keeping your accounts with a perfect history open. After seven years, the bad information will drop off and your good information will stay.

Don't apply for lots of new credit if you want your score to go up. Patience and time will fix it. Also, make sure to dispute inaccurate negative information on your credit report. You can get a [free credit report](#) annually by law.

Short-Term Steps to Improve Your Credit Score

The first step in improving your long-term score is to make sure you are doing things right today. If you have a credit card balance, pay it off and always make payments on-time. If you have a loan, make at least the minimum payments every period. You should know if you have a problem in your history at this point from the steps above. If you do, it may take up to 7 years for negative information to drop from your report. That is why doing the right thing now is so important. If you are starting on your path to perfect credit for the first time today, you will be there in 7 years if you stick to it.

The number one thing you can do today to increase your credit score as quickly as possible is to pay off credit card balances to zero.

Remember that any "instant repair" offers you see are misleading. No one can do anything to fix your credit report and credit score other than you. It takes a long time to fix your credit, so make sure to start right away to get going on the right track.

Long-Term Steps to Improve Your Credit Score

Review Your Credit Report 3 Times a Year

You can get a free copy of your credit report from each of the major agencies once per year by law, but that doesn't mean you should check them all at once. I spread them out so I can check my credit report every four months. You can get your free credit report from annualcreditreport.com.

Annual Credit Report is the only government mandated site to get your free credit report, any other site is trying to charge you for something you can get for free. Don't waste your money on them.

Report Any Errors You Find

If you find inaccurate negative information, report it to the credit bureau and get it removed from your report. While you can't remove accurate information, you should take the steps to move inaccurate information. I have done this before, and it was worth the time it took to fix my report.

To start the process, file a report with the credit bureau or contact the bank that reported the incorrect information on your report.

Eliminate Debt

While most of us don't have enough cash on hand to pay off any outstanding debt right away, make a plan to pay it off over time. I used the debt snowball to pay for a car loan and school loans. I [paid off my \\$90,000 education in 2 years](#). I am not that special, if I can do it, so can you.

Remove Negative Information and Keep Positive Accounts

Ultimately you want to keep all of the positive information and remove the negative information from your report. The next sections outline removing old information and keeping the good.

Negative Information Remains on Your Credit Report a Long Time

Negative information is anything ranging from a late payment to a bankruptcy. Regardless of what "credit repair" agencies tell you, they cannot legally help you remove any accurate negative information from your credit report. It is there as long as mandated by the credit reporting agencies, Experian, Equifax, and TransUnion.

- Late payments – 7 years
- Judgment – 7 years
- Short Sale – 7 years
- Foreclosure – 7 years
- Tax Liens – 7 years from the final payment date
- Chapter 13 Bankruptcy – 7 years
- Chapter 7 Bankruptcy – 10 years

Improve Your Credit Utilization Ratio and Manage Your Credit Limits



Credit companies have become more cautious when issuing new credit, and some banks are even cutting credit for people with inactive accounts and increased credit risk. This can have important and costly ramifications on your credit, so it is important to understand how scores are calculated and what your credit limits mean.

What are Credit Limits?

Credit limits are one of the most basic parts of a revolving credit account. When you get a new credit card, the bank decides how risky you are and how much they would be willing to lend you. A college student with no credit history may be given a \$500 limit while a homeowner with a long history may get a credit line over \$100,000. My first credit card had a \$700 limit. I have credit cards with limits well over \$20,000 today.

How to Keep Cards Active

I once had a bank close one of my credit cards for inactivity. Having worked in a bank, I used to look at inactivity reports to decide which accounts should be shut down. It is really easy to avoid those reports.

To keep your account active, just use it every once in a while. I have around 10 open credit cards. I only use one every day. For the rest, I grab the stack a couple of times each year and buy lunch or gas or a small purchase on each card and pay it off right away. That keeps your account active, your limits high, and your ratio low.

How to Get Higher Limits

If you have a few cards with low limits, the easiest way to raise your total available credit is to ask. I have filled out the form at Citibank before and had an instant credit line increase of thousands of dollars. On an old MBNA card, I wanted a higher limit so I called and asked. They asked why I needed a higher limit so I told them I was planning a big trip and wanted to book everything on that card. They glanced at my payment history, which was flawless, and doubled my credit card limit on the spot.

New Credit Can Lower Your Score in the Short Term

One word of caution when seeking higher limits. New credit makes up 10% of your score. More new credit is considered a bad thing, so if you are planning on buying a home with a mortgage or seeking any new loan in the near future, hold off on getting new credit cards or submitting other applications.

How to Fix Errors on Your Credit Report

On occasion, banks report incorrect information on your credit report, which can dramatically lower your credit score and lower your ability to get a new loan at the best possible rate. I have found [errors on my credit report](#) in the past, and took the steps to get them fixed.

The first step is to contact the financial institution that reported the incorrect information and try to work with them to make a correction. Corrections can take months to show up, so it is important to set calendar reminders and check on your report on occasion to verify that changes were made, if the bank agrees to make the changes.

If you don't have any luck there, contact the credit reporting bureau directly. Equifax, Experian, and TransUnion each have large dispute departments and can help expedite and mediate any incorrect information and work with you to verify that the information is incorrect and needs to be fixed.

This can be a frustrating process, but having a good credit score can save you tens of thousands of dollars on mortgages and other loans. A bad score can also keep you from the best credit cards, such as those with the best [miles and points for travel hacking](#).

Is Closing a Credit Card a Good Idea?



People have lots of misconceptions about credit cards. Is opening more good for your credit score? Is closing a card good for your score? Do you want high limits or low limits? Do I need to use my card often to increase my score? Today, I'll address one big misconception on whether or not it is a good idea to close a credit card.

Credit Utilization

30% of your credit score is determined by outstanding debts. The biggest factor in that part of your score is your credit utilization ratio.

Credit scoring companies think it's bad if you max out your cards or use a super high percentage of available credit. Banks and lenders agree. To keep your score high, keep your balances low. 20% of available credit is a good reference point to use, though 0% is better!

For example, if you have a \$10,000 limit on a card, you should always keep your balance under \$2,000 to help keep your credit score high. But that 20% rule is not applied per account, it is across all revolving credit accounts.

If you have 3 accounts with a \$3,333 limit (total of \$10,000) and have a \$2,000 combined balance, your ratio is 20%. If you close one but keep the \$2,000 outstanding, your ratio just jumped to 30%, giving you a bad spot on your credit report.

Even if you never carry a balance, it can't hurt having extra cushion for unexpected situations

Average Age of Credit

The average age of open credit accounts and length of your credit history makes up 15% of your credit score.

Every time you open a new account, it lowers your average age of credit. If you have an account open for a long time, it raises your average age. If you have an old account and close it, your average age of credit stops increasing and that account will eventually stop being counted in the average.

To keep your credit score high, keep your accounts open as long as you can. I usually charge something small, like a \$5-\$10 lunch, on each card 1-2 times per year to ensure they are still “active accounts” and are not at risk to be shut down by the credit card company.

Annual Fees

BUT... There’s always a but.

As you read above, it is almost always best to keep your credit cards open, even if you don’t regularly use them. The big however is from annual fees.

If your card charges an annual fee, and you don’t use it, you are just throwing money away. Some cards are worth a fee if you are going to get a great benefit. I happily pay a fee on my [Starwood American Express](#) card because the benefits are so valuable.

If I did not get the value from the benefits, there would be no reason to keep the card open and keep paying for it.

Some banks will let you convert a card to one without an annual fee. That is the best option if you are able.

The Quest for an 850 Credit Score is Dead

When I started this site in 2008, I made it a goal to try to get a "perfect" credit score. Because the highest score possible is 850, I made that my goal. However, I realized over the years since that an 850 credit score could hurt me more than it could help me.

Logically, the goal in any pursuit is to be the best. Students try for 100% on tests. Athletes try for undefeated seasons. Bankers try for zero defaults. Consumers try for perfect credit scores. Hypothetically, a perfect credit score should not be difficult to attain. Keep your accounts open for a long time, never have a late payment, and you should be on the way. However, is it worth it?

750 vs. 850

There is a point that having a better credit score does not matter anymore. A credit score of 750 is considered "excellent" by most banks and lenders. At that score, you are going to qualify for the best possible interest rates.

So what is the difference if your credit score is 750 or 800 or 850? There isn't really a difference. Unless you are a finance guru that needs to be able to prove how awesome you are or an asshole that brags about your credit score, it does not matter.

Why This Matters

I sign up for new credit cards all the time. Right now I have 15 of them. I am also planning to close a credit card with an annual fee. This will have two negative impacts on my credit score. It will shorten my average age of credit and possibly lower my available credit, giving me a higher used credit percentage.

However, my credit score will only fall by about 10 points. My score will still get me the best possible loan rates if I decide to get a new car loan or buy a new home.

Cancelling the old card will save me a \$95 annual fee and the new card will get me 50,000 bonus points with bonuses for transferring to miles from Chase Ultimate Rewards. This could be worth two round trip flights in the US or one international round trip flight.

Your Credit Score is a Moving Metric

Your credit score is always changing. New credit, aging credit, on time payments, and new loans are common for people with good credit scores. If you always pay on time and manage your credit responsibly, you don't have to worry about having credit that is not excellent.

Don't worry too much about the extra points on your score. Do what you can to take advantage of great offers and discounts. Unless you screw up, your excellent credit isn't going anywhere.

Take Control of Your Credit

I can't tell you how many times I've come across someone blaming other people for their bad credit or personal finance situation. For us, that ends today. You control your credit cards and loans. Now you know how they work, so you are the only person in control of your credit report and credit score.

If you have not already, sign up for [Credit Sesame](#) and [Quizze](#) to make sure you know what is happening on a regular basis. Check your AnnualCreditReport.com credit report at least once a year (I get the three reports spread out every four months). You have the tools and the knowledge to have excellent credit. Now it is time to make it happen.