How to Improve Your Credit

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Introduction

If you're interested in improving your credit, you've come to the right place. This whitepaper will provide you with an understanding of credit and credit scores, as well as the tools you need to understand how to build good credit.

This document is designed to take you from knowing little or nothing about credit to becoming an adept manager of your own credit. All it will take is a few pages of reading, so let's get started!

What is Credit?

In its most basic sense, credit is a lender's confidence in a particular borrower's ability to pay back a loan. Put another way, credit is the amount of trust a lender is willing to place in that borrower. A person with "excellent credit" hasn't given lenders any reason to doubt his or her ability to repay a borrowed amount of money. A person with "poor credit," on the other hand, likely has.[1]

A person's credit is frequently expressed in numerical form as a credit score. A credit score always falls within a certain range of numbers, and the closer your score is to the high end of that range, the better your score and the better your credit.

Credit has been an important component of economic systems for millennia,[2] allowing people (and organizations and nations, too) to obtain goods and services now in return for a promise to pay later. While making use of your credit to borrow money has the potential to leave you in difficult financial circumstances without proper care, it can also allow you to benefit from goods and services that it might otherwise take you a long time to afford. The key to responsible credit use is never to take on more debt than you will be able to pay off.

Credit is rarely free, as a borrower is typically required to pay back more than the amount originally borrowed. But in many cases, borrowers consider this extra cost worth it. The homeowner who can move into a house decades before she would otherwise be able may attest to this.

Since most people make use of credit at some point in their lives, it makes sense to be interested in improving your credit or, if your credit is already good, maintaining it. After all, having good credit means that when you do take on debt — whether it's an installment loan, a payday loan, a credit card or a home mortgage — you'll likely be approved and get good terms.

The good news is that even if your credit is currently less than ideal, there are many things you can do to improve it. It is very difficult to damage your credit beyond repair, meaning that you will almost always have an opportunity to get your credit back on track given time and effort. Though there are countless companies out there offering to quickly improve your credit score, the reality is that it takes time and consistent effort to build credit and rectify errors and past lapses.[3] That's why it's important to understand how credit works from the ground up before getting started. This whitepaper is designed to give you that understanding, and we hope it will provide you with the tools and knowledge you need to build and maintain good credit.

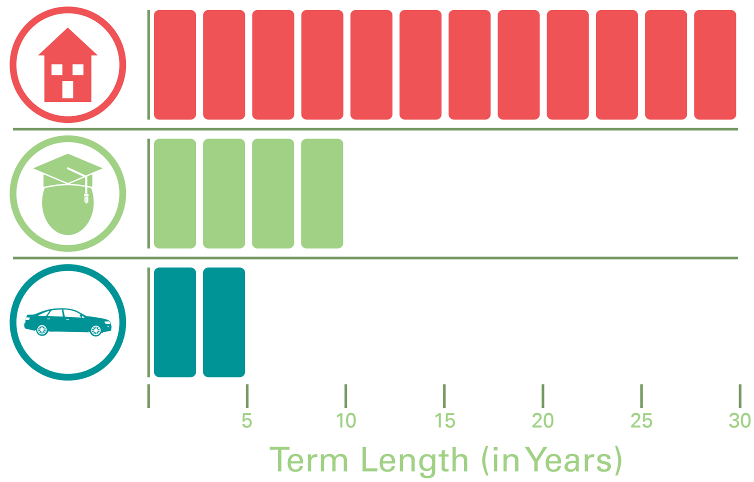
How is credit used?

Though "credit" often describes a lender's trust in a particular borrower, the term is also used to refer to the particular ways in which this trust allows money to change hands. For instance, both credit cards and home mortgages are considered forms of credit.

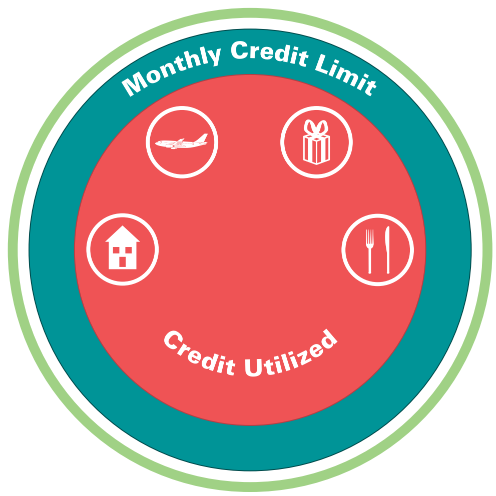
The two most prevalent types of credit available to everyday consumers are called installment credit and revolving credit:

- Installment credit consists of loans that are repaid over time, usually in a series of fixed payments. Examples of installment credit are: car loans, home mortgages, student loans, personal loans, home improvement loans and land loans.[4]
- Revolving credit allows a consumer to repeatedly borrow up to a predetermined amount each month, provided his or her account remains in good standing. This type of credit can be unsecured, as with a credit card, or secured, as with a home equity line of credit, which requires a concrete asset to stand behind your promise to pay. Examples of revolving credit are: credit cards and lines of credit.[5]

Installment credit



Revolving credit



Credit Scores and Credit Reports

Information about your credit history is routinely gathered by organizations called credit bureaus. Each credit bureau has its own collection of data about you, which usually includes personal information, collections information, public records information and information on payment history and outstanding debts. Taken together, all this information about you makes up your credit file.[6] Since there are multiple credit bureaus, you have multiple credit files — one in each bureau. Credit bureaus obtain the information for your credit file from creditors, lenders, utilities and debt collection agencies, among other sources.[7]

No one except the bureaus themselves ever sees the entirety of your credit file.[6] Your credit report, however, can be seen by others. Your credit report is simply a collection of the most relevant pieces of information contained in your credit file.[6] Your credit score, in turn, is calculated from the information contained in your credit report, and this score gives lenders a quick idea of how likely you are to repay a loan based on your credit history.[9]

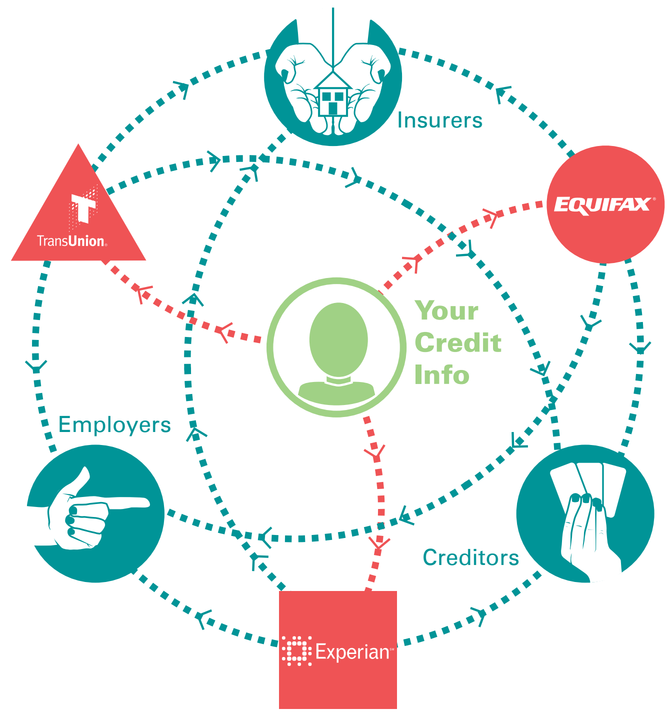
There are three primary national credit bureaus who maintain your credit files: Equifax, Experian and TransUnion.[10] Your credit files may vary somewhat between the different bureaus, depending on their particular data sources, meaning that your credit report and credit score may vary according to which bureau's files are used.

Though they are subject to the oversight of the Federal Trade Commission, credit bureaus are businesses, not governmental organizations.[7] They profit by selling your credit report to creditors, employers, insurers, and other parties who wish to evaluate your credit history.[10] Because it is time-consuming to evaluate all the items in a person's credit report, these parties may look only or primarily at an individual's credit score, because it provides a quicker way of evaluating that person's credit history.

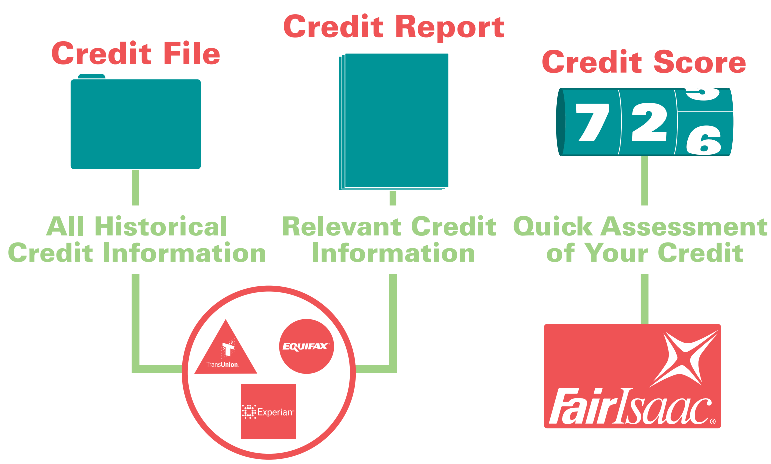
Who calculates your credit score?

The first thing to know about credit scores is that you don't have only one. There are actually numerous organizations who calculate credit scores, using unique methodologies to evaluate the information in your credit report. However, a company called Fair Isaac Corporation (more commonly known as "FICO") is the industry leader in calculating credit scores. Their credit score, called a FICO Score, is a number between 300 and 850, where a higher score reflects better credit.[9] Each person technically has three FICO Scores — one corresponding to the particular data in each of the three major credit bureaus' files.[11]

Where does my credit information go?



File vs. Report vs. Score



How is your credit score determined?

If you're concerned about your credit score, it's important to familiarize yourself with how it's calculated so you can understand the reasons for your current score and make plans for raising your score in the future. To the right is a chart depicting the FICO scoring methodology. This is just a general breakdown of the scoring system; the importance of individual factors may vary from person to person depending on their unique credit history.[12]

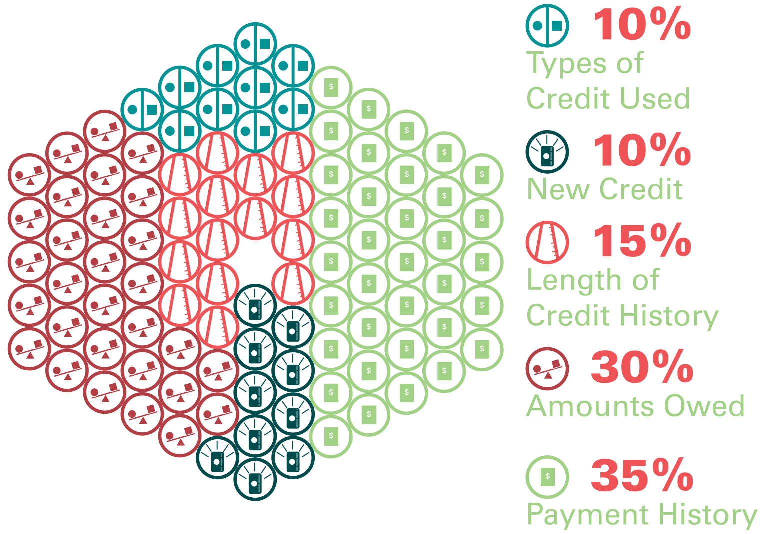
This section will break down the components of your FICO Score, with the weight of each component appearing in parentheses:

Payment history (35%): This category takes into consideration any late payments, charge-offs, collections, foreclosures, bankruptcies or other similar negative items.[13] The more recent and more severe the negative item, the worse it affects your score. On the other hand, if your credit accounts have a good history, your score will benefit.[14]

Amounts owed (30%): This category factors in the amounts and types of debt in your credit history. The two most important types are revolving debt and installment debt:

- Revolving debt is the most important component of FICO's debt category, taking into consideration credit card and retail card debt. The higher your past and current credit card balances are in comparison to your credit card limits, the more adversely your score will be affected.
- Installment debt is not as important to your FICO Score as revolving debt. It refers to loans that a borrower repays over an extended period of time. As with revolving debt, using a large portion of available credit can factor negatively into your FICO Score.[15]

Components of a FICO score



Length of credit history (15%): If your credit history is very short, your credit score may suffer. This is because a longer history helps demonstrate stability and responsibility. Both the age of your credit file and the average age of the accounts in it play a role.[12]

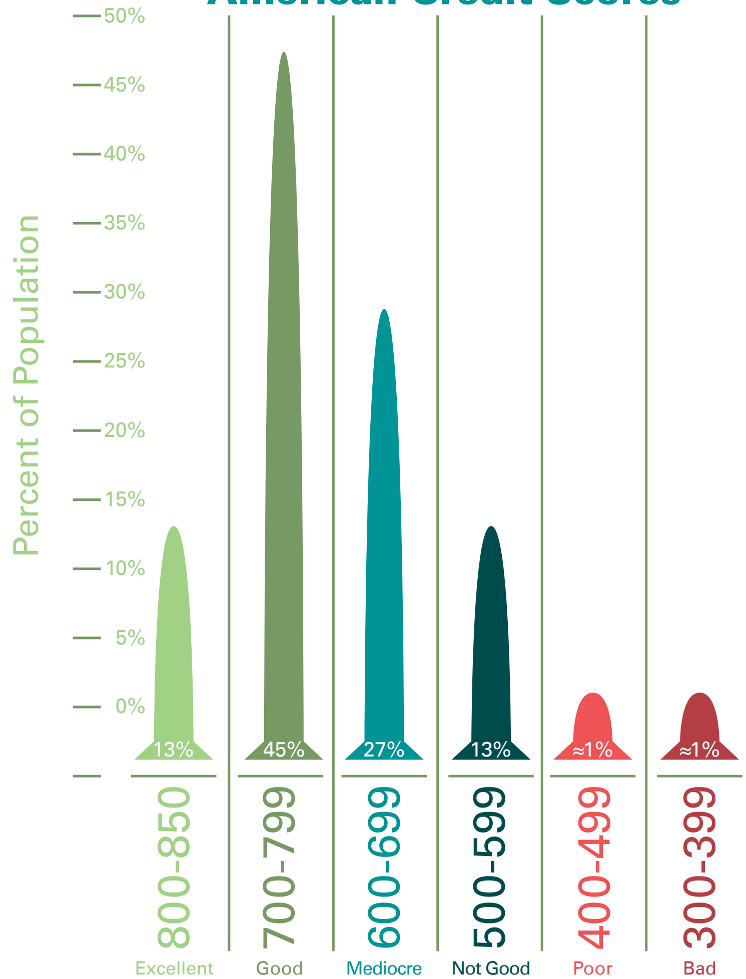
Types of credit in use (10%): If you have used various types of accounts (for instance, installment, revolving, auto, mortgage, etc.), this will benefit your credit score.[16]

New credit (10%): Making many inquiries seeking new credit can harm your credit score, especially if the inquiries are over a short period of time.[12]

More on Credit Scoring

A credit score above 700 is considered good,[17] while a score above 760 is likely to get the best interest rates.[18] Employment information like salary, occupation and employment history won't affect your credit score, though lenders may take this information into consideration in making approval decisions.[17] Keep in mind that many of the largest lenders, including credit card companies, have developed their own scoring systems for evaluating borrowers' credit, and may not rely on FICO Scores.[9]

American Credit Scores



If there are some blemishes on your credit history, the good news is that they will not remain on your credit report forever. When they disappear from your credit report, they will also stop affecting your credit score. Most negative information in your credit history can be reported for a maximum of seven years, while bankruptcy information can be reported for 10 years. However, there's no time limit for reporting information on criminal convictions or information related to your application for over $150,000 worth of credit or life insurance.[19]

A good history of rent, utility and insurance payments is not usually factored into your credit report or credit score. However, delinquencies on these payments can be reported to the credit bureaus and may show up in your credit report and credit score.[20, 21]

How to check your credit score

If you want to see your credit score, you'll probably have to pay a fee. If you're not sure which type of credit score to check, keep in mind that the most commonly used credit score is the FICO Score,[9] which, according to FICO, is used in more than 90 percent of lending decisions.[22] You can obtain yours by going to www.myfico.com. Your VantageScore credit score, another important version, can be obtained here: www.vantagescore.com. There are also a number of other types of credit scores available.[9]

If you find that a lender, insurer, employer or other party is going to factor your credit score into a decision that will affect you, you may want to be aware of where your credit score stands. If you find that this party relies on a score other than FICO and VantageScore, you may wish to check that score instead.

Checking your credit report

While checking your credit score will make you aware of what many creditors and others see, it will not give you any explanation for your score. In order to understand the reasons for your particular score, you'll have to find out what information is contained in your credit report, because it's on this report that your credit score is based.

The Fair Credit Reporting Act requires that all national consumer credit reporting agencies (including the three major credit bureaus — Equifax, Experian and TransUnion) provide you with a free copy of your credit report upon request once every 12 months.[23] (If you recall, your credit report is just a collection of the most relevant information in your credit file.[6])

To get free reports from the three major credit bureaus, visit www.annualcreditreport.com. You can order a report from one, two or all three of the bureaus. If you plan to order reports from more than one, you can do so at one time or you can stagger them if you want to have free access to a credit report at various times during the year.[8] The Federal Trade Commission warns that many imposter sites may claim to offer free credit reports, but that the only website authorized to provide your free annual credit report is annualcreditreport.com.[8]

In order to retrieve your credit report at annualcreditreport.com, you will have to provide your name, address, Social Security number and date of birth. You may also need to provide other information to prove your identity. You will be able to gain access to your credit report immediately online, whereas if you order your report by mail or over the phone, your report will be mailed to you within 15 days of receipt of your request.[8]

Checking your credit report is a good idea because it allows you to ensure that all your information is accurate and up-to-date. It can also help you guard against identity theft, because the activity of an identity thief will often show up on your credit report. In the "Improving your credit" section of this whitepaper, you'll learn more about how checking your credit report can help you improve your credit.[8]

If you want to learn more about credit reports, you can visit the Federal Trade Commission's page on access to free credit reports at http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre34.shtm.

The bottom line on checking your credit score is that there's no need to check it unless you feel knowing your score would be an advantage. When it comes to your credit report, however, it's recommended that you check it on a routine basis to make sure it contains no errors.

Why Does Credit Matter?

Believe it or not, having good credit doesn't only matter when you're applying for credit. Many different organizations, from insurers to phone companies, use your credit information to determine the amount of risk they'd be taking on by doing business with you.[24]

Often, these organizations have found that your credit report and/or credit score can be good predictors of your behavior in relation to the services they offer. For instance, some insurance companies use information on your credit history to help predict your likelihood of filing an insurance claim, as well as the amount that claim will likely be.[25] In an even more basic sense, many organizations simply look at your credit score to help evaluate your level of responsibility and discipline.[26]

Here are the most common types of organizations that check your credit score and/or credit report:

- Lenders use your credit score to determine whether you'd be a good candidate for a loan, and if so, on what terms. This includes credit card companies and banks.[25]
- Insurance companies often base their premium rates on your credit history.[27]
- Landlords may look at your credit report and score to evaluate whether you're likely to pay rent on time.[27]
- Cell phone and utility companies may check your credit to help determine whether to approve you, and if so, on what terms. A poor credit history can mean being denied service, having to pay higher rates, or having to meet additional requirements.[27]
- Employers, whether current or prospective, are allowed to request your credit report in most states,[28] though they cannot see your credit score.[29] Employers must obtain your permission before accessing your credit report, and if information in the report influences a decision on the part of the employer that negatively impacts you, the employer must notify you and provide you with a copy of the report.[29] (For more information, see http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre34.shtm.)

Who checks your credit?

Improving Your Credit

If you want to improve your credit, it's important to understand that no matter what you do, negative items on your credit report will remain there until they're scheduled to expire. There's nothing you can do to erase negative items, provided they are accurate. But you can build other solid credit that will help offset the impact of those negative items, and in time those negative items will disappear. The key is to take a proactive approach to building credit without overextending yourself.

Since you can't directly control your credit score, all you can do is focus on making positive changes that will be reflected in your credit report. Those changes will over time be incorporated into your credit score.

Here are some of the best things you can do to improve your credit:

1. Make your payments on time

Your payment history is the single biggest factor in determining your FICO Score, revealing that this is an area of particular interest to many organizations. If you can commit to making all payments on time from now on, you will begin to improve this area of your report. This means payments on all kinds of debt, from personal loans to a mortgage to utility bills.[13, 20] Keep in mind that even one delinquency can significantly affect your credit score,[30] and that having an account referred to a collection agency or declaring bankruptcy should be avoided if at all possible.[31] If failing to pay on time is sometimes due to forgetfulness, consider setting up automatic payments.

The most recent items in your credit history weigh the most, so by committing to make all payments on time from now on, you'll be doing a lot of good for your credit score. If you ever do have trouble making payments, be sure to notify your creditors ahead of time. And if you think you may benefit from seeking credit counseling, note that this will generally not harm your FICO Score.[14]

2. Reduce your amounts owed

When it comes to your FICO Score, the amount of money you owe is a close second in importance to your payment history.[15] But certain types of debt are weighed more heavily than others. For instance, paying off your revolving debt, such as credit cards, will improve your credit score a lot more than paying off installment loans, such as a home mortgage. Erasing your credit card debt can sometimes raise your credit score by as much as 100 points.[30]

It's also important to keep your credit card utilization in check. This means charging as little as 10 percent of your credit limit each month if possible. Credit card companies report the amount you charge each month as well as your credit limit.[30]

3. If you don't have a credit history, start one

The length of your credit history counts 15 percent toward your credit score.[12] A long credit history allows you to show consistency and responsibility in your credit management, so the longer your history, the better chance you have at a high score. If you don't yet have a credit history, it will benefit you to start one now, as long as you do so within the context of the other recommendations in this section. Make sure not to open multiple new accounts too rapidly.[14]

4. Limit your applications for new credit

If you apply for many new loans or lines of credit, this can hurt your credit.[12] So when you shop around for a loan, make sure to limit the period of time in which you do so; the length of time between your inquiries is one way FICO determines whether you're shopping for a single loan or multiple ones.[14]

Viewing your own credit report or score will not harm your credit, nor will creditors checking your report or score to make prescreened offers.[31]

5. Use different types of credit

Demonstrating responsibility with multiple types of credit can raise your score. In particular, it's helpful to have both installment loans and credit cards, as long as you pay on time. FICO states that someone without a credit card would be considered a higher risk than someone who has demonstrated responsibility with a credit card.[14]

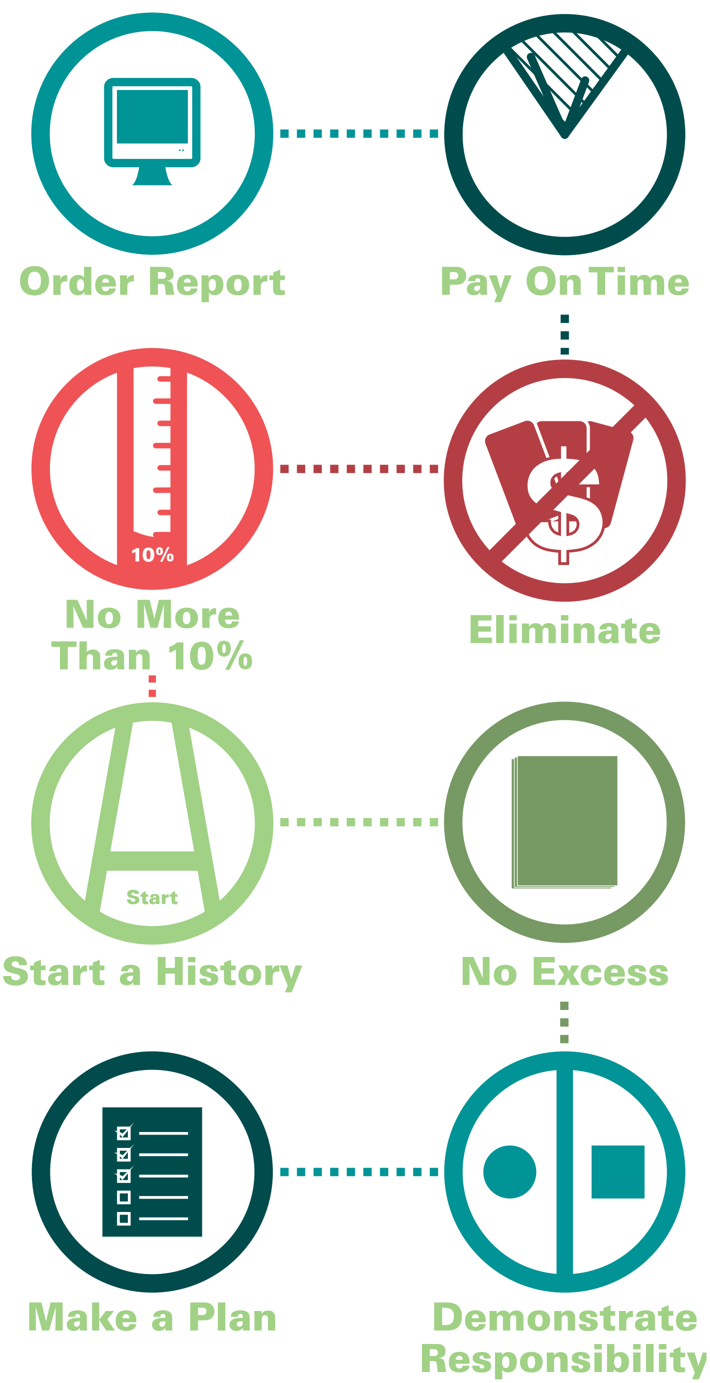
6. Fix errors in your credit report

One of the best reasons to request a credit report is to verify that there is no inaccurate negative information contained in it. For instance, if a late payment is incorrectly listed for one of your accounts, or if your amount owed is too high, your credit score may be unfairly harmed. If you find an error in your credit report, visit the Federal Trade Commission's page on disputing errors to learn more: http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre21.shtm.

Summary of ways to improve your credit

Improving your credit can seem intimidating because it involves an understanding of terms and concepts that you might not have known. Hopefully, this whitepaper has made this knowledge both accessible and understandable. For added clarity, the following list summarizes the most important things you can do to improve your credit:

How to improve your credit



- Order a free credit report and check it for inaccurate information.
- Ensure that you make all payments on time from now on. Slowly but surely, these on-time payments will begin to outweigh past lapses.
- Do your best to eliminate credit card debt.
- Don't charge more than 10 percent of your monthly credit limit if possible.
- Start a credit history if you don't already have one.
- Don't excessively apply for new loans or lines of credit.
- Demonstrate your responsibility with both installment and revolving credit.
- Make a plan for improving your credit and stick to it!

How long before you see improvements in your score

The amount of time it will take before you see improvements in your credit score depends on the kinds of negative items in your credit file and how easily you can demonstrate improved credit responsibility. Remember that delinquencies and most public record items remain on your credit report for seven years, while bankruptcies can remain for 10 years.[32]

Once a blemish disappears from your credit record, it will no longer factor into your score. But even before that happens, negative items begin to matter less to your score as they age. There's no way to say exactly how long it will take you to raise your credit score to your desired goal, but if you stick to solid financial habits, you can be assured that your credit score will steadily climb. In the case of delinquencies and minor blemishes, you can often return your credit to good health in a matter of months.[33]

Conclusion

Now that you understand how credit works and you know what it takes to build good credit, you're well on your way to achieving your credit goals. However, reading this whitepaper is only the first part of your journey. From here, you'll need to implement a plan of action that will set you on a path toward good credit and keep you honest along the way.

Start by identifying the ways in which you plan to improve your credit, and then write down how and when you will accomplish them. Don't put too much on your plate at once, but instead set a manageable amount of small goals each month that will steadily bring you closer to your desired outcome.

Don't forget to clearly define your goals. By setting a concrete destination for yourself — whether it's a long series of on-time payments or a particular increase in your credit score — you will know exactly what you're working toward. As you make progress, you will find inspiration in watching your credit improve.

When you have achieved what you set out to do, you will have established the kind of financial responsibility that good credit is based on. And by maintaining those good habits, you will be able to feel confident in the health of your credit for years to come.

Addendum: Getting Out of Debt

If you're in debt and you aren't making progress on paying it off, then establishing a plan to do so should be your top priority. You won't be able to keep your credit afloat for very long under a growing mountain of debt, and there are many other reasons not to let debt get out of hand.

By working toward eliminating your debt now, you'll be protecting your credit for the long term. Most blemishes on your credit report only remain there for seven to 10 years, so by paying off your debt you'll have a great chance of rebuilding your credit in the future — an opportunity you won't get if your debt continues to increase.

Here are some ways you can tackle your debt:

Set a budget

The best way to begin your journey out of debt is to gain a clear picture of your finances. Begin by writing down all your expenditures and then separating the recurring ones, like rent and utilities, from ones that vary, like clothing and entertainment. Writing these down will give you a clearer understanding of where your money is going, and you can then develop a budget that will keep your expenses in check and maximize the money you can put toward your debts.[3] Spend some time reevaluating whether you're getting the best deal on your recurring payments, and try to keep your non-recurring payments to a minimum.

Communicate with your creditors

If you can't make a payment on time, it's better to communicate your situation to your creditors than to allow them to make assumptions about you that may not be true. You may be able to work out a modified payment plan that will allow you to proceed in good standing.

Prioritize your debts

All debts are not equal. Secured debts are debts that require assets to back them up, such as your house or car. If you have secured debts and you fail to pay them, your assets could be taken away from you. So make sure not to fall behind on your secured debts. You should also think about how much interest each of your debts costs you. By paying off higher-interest debts first, you will save yourself money in the long run.[34]

Consolidating debt

By consolidating multiple debts, you can sometimes benefit from more favorable terms. If you're not sure where to begin, consider contacting a credit counseling organization, which can help give you the advice you need to get out of debt.

When you make a plan for eliminating your debt, don't be discouraged if it precludes you from taking additional steps toward improving your credit. Remember that your credit will benefit from consistent on-time payments and the reduction in your debt load.

For more information on how to get out of debt, see section 3 of the Federal Trade Commission's publication entitled "Building a Better Credit Report": http://www.consumer.ftc.gov/articles/pdf-0032-building-a-better-credit-report.pdf.

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