INTRODUCTION TO CREDIT

What is credit? Dictionaries define it as "the trust which allows one party to provide money or resources to another party where that second party does not reimburse the first party immediately, but instead promises either to repay or return those resources at a later date."

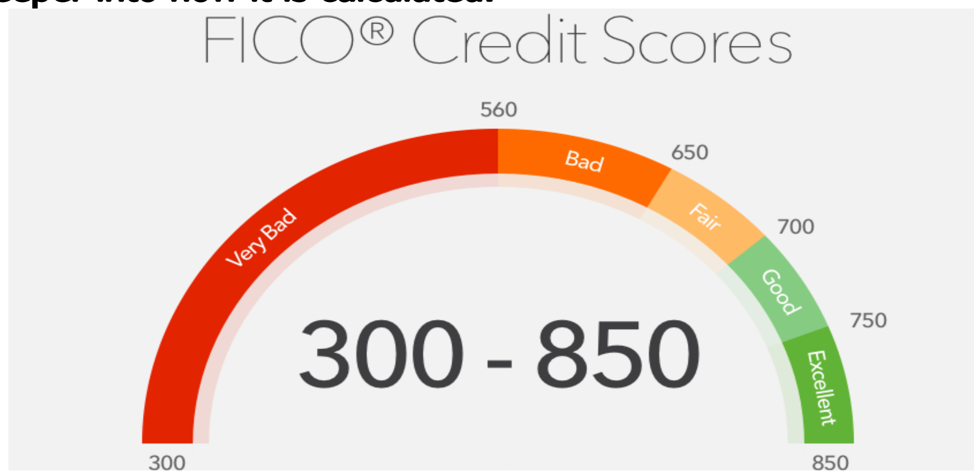
Woah... Let's break that down: a creditor (bank, credit company, etc.) allows you to spend some of their money and trusts you will pay it back when it's due. While it sounds like an easy deal, another thing to keep in mind is that credit is not free money. It is debt, and how you handle that debt is very important.

Outside entities can look at how you handle credit and use that to assume how you handle your finances. This could affect where you live, what you drive, and even where you work. It's serious stuff, but what's worse: you don't need any of that knowledge in order to get credit! That can lead to some serious debt trouble.

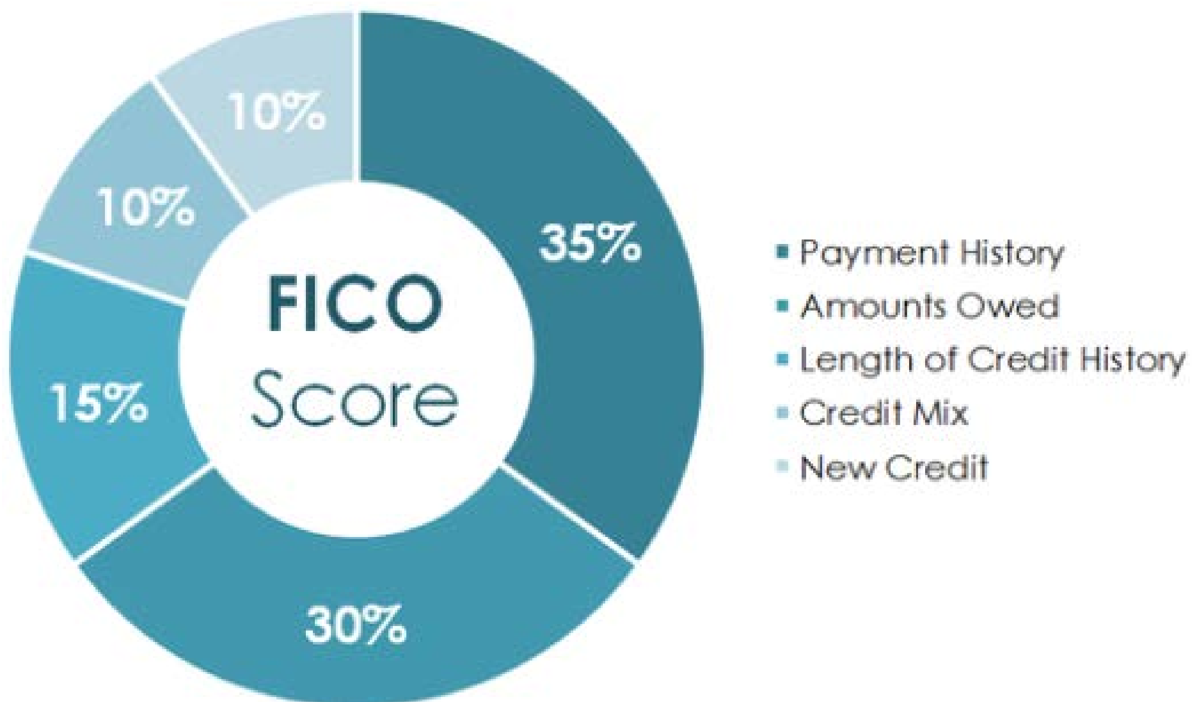
As you read this, you may already be in debt trouble, or just trying to get more info. No matter your situation, education is the key to get back on track. Here you'll be able to get information about credit, the importance of good credit, and how to properly use credit. With that you'll also get to know about the credit score, what affects it, and how to improve it.

THE CREDIT SCORE: WHAT AFFECTS IT?

The credit score is an interesting topic to discuss. As you've probably learned in the last lesson, credit is used by lenders to determine your trustworthiness or risk level in regards to repaying the terms of the agreement to borrow funds. To make things a little easier, the credit score was developed to score your overall trustworthiness/risk level. There are multiple companies that develop credit scores, however, the most widely-used company is the Fair Isaac Corporation (commonly referred to as the FICO score). The FICO Score is used by approximately 90% of lenders, so we're going to dive a little deeper into how it is calculated.



Five categories make up the FICO score:
Payment History, Amounts Owed, Length of Credit History, Credit Mix, and New Credit.



PAYMENT HISTORY

This particular category accounts for 35% of your credit score. Of course, the lenders want to know how you've paid your accounts in the past. The account types can include major credit cards, department store cards, and loans. This category has the largest effect on your credit score.

AMOUNTS OWED

This category accounts for 30% of your credit score. This category takes into account several factors, including the amount owed on all accounts, credit utilization, and the number of accounts with balances. Owing money on your credit accounts doesn't necessarily mean that you're a high risk borrower. However, when a high percentage of your available credit has been used, the lender could assume that you're being overextended, which in turn could make you more likely to make late payments or miss payments. A good rule of thumb is to keep all revolving credit accounts under 30% utilization. For example, if you have a credit card with a $1,000 limit, you should try keep at least $700 available at all times.

LENGTH OF CREDIT HISTORY

This category accounts for 15% of your credit score. Generally, a longer credit history will increase your score. This one is pretty much self-explanatory.

CREDIT MIX

This category accounts for 10% of your credit score. There are different types of credit accounts. There are revolving accounts, installment accounts, and mortgage accounts, to name a few. A credit card is considered a revolving account because when you pay the borrowed amount to the lender, your available balance increases to reflect it. A loan from a bank is considered an installment loan, because the borrowed money is given to you upfront and once you pay it back, the loan is closed. Mortgage accounts are like installment loans, but the lender puts it in its own sub-category because the amounts usually associated with mortgages are significantly higher. Keep in mind that it's not necessary to have multiple account types because this category only accounts for 10% of your score.

NEW CREDIT

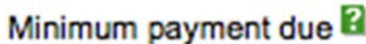
The last category accounts for 10% of your credit score. The lenders tend to believe that opening too many accounts in a short period of time represents a greater risk. Included in this category is credit inquiries, which pretty much means that a lender has requested to check your credit report and score as a result of you applying for new credit. FICO tends to recognize if you're rate shopping for a certain account type and will count multiple inquiries as one.

Now that we know everything that affects our credit score, we should have a better perspective of the things that will help improve it.

THE CREDIT SCORE (HOW TO IMPROVE IT?)

As an organization, we believe cash on hand is the best route to go when furthering your financial future. For the people who have credit, we would like to teach you ways to improve your credit. Ways on improving your credit score can be broken down into seven steps.

1. Monitor your credit card balances.
2. Eliminate credit card balances.
3. Leave old debt on your report.
4. Monitor your calendar.
5. Pay bills on time.
6. Don't hint at risk.
7. Don't obsess.



MONITOR YOUR CREDIT CARD BALANCES

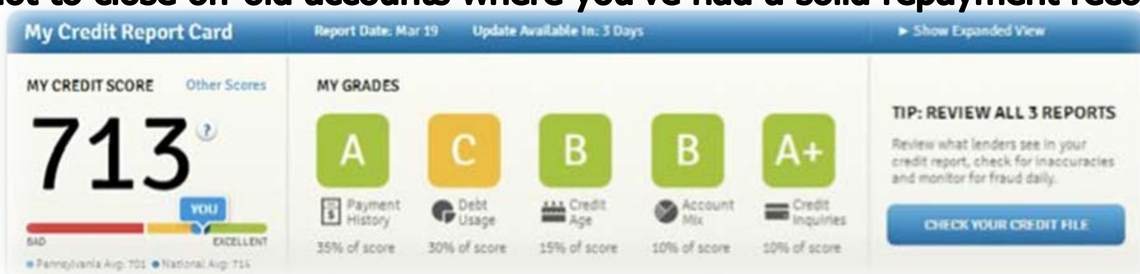
A major factor in your credit score is the usage of credit cards. A higher usage of your credit cards can make a negative impact on your credit score. The optimum percentage is 30 in order to help improve your credit score. Some people are unaware that despite paying your balance off monthly in full, you could still have a higher utilization ratio. Some issuers use the balance on your statement as the one reported to the bureau.

ELIMINATE CREDIT CARD BALANCES

"A good way to improve your credit score is to eliminate nuisance balances," says John Ulzheimer, a nationally recognized credit expert formerly of FICO and Equifax. This would be the small balances that you have on multiple credit cards. Make sure your usage on those credit cards are under 30 percent and not maxing out your cards.

LEAVE OLD DEBT ON YOUR CREDIT REPORT

Debt that you've handled well and paid as agree is good for your credit score. The longer your history of debt being paid off on time, the better it is for your score. Often after paying off a home or car, some people attempt to get it removed from their credit report which isn't a good idea. Leaving it on your credit report will actually help your score due to being well managed for a long period of time. This is also a good reason not to close off old accounts where you've had a solid repayment record.



MONITOR YOUR CALENDAR

Every time you apply for credit, it can cause a small dip in your credit score that lasts a year. That's because if someone is making multiple applications for credit, it usually means he or she wants to use more credit. However, with three kinds of loans - mortgage, auto and more recently, student loans - scoring formulas allow for the fact that you'll make multiple applications but take out only one loan. The FICO score, a credit score commonly used by lenders, ignores any such inquiries made in the 30 days prior to scoring. If it finds some that are older than 30 days, it will count those made within a typical shopping period as just one inquiry.

DON'T HINT AT RISK

Sometimes, one of the best ways to improve your credit score is to not do something that could sink it. Two of the biggies are missing payments and suddenly paying less (or charging more) than you normally do, says Dave Jones, retired president of the Association of Independent Consumer Credit Counseling Agencies. Other changes that could scare your card issuer (but not necessarily hurt your credit score): taking cash advances or even using your cards at businesses that could indicate current or future money stress, such as a pawnshop or a divorce attorney, he says. "You just don't want to do anything that would indicate risk," Jones says.

DON'T OBSESS

You should be focused on your credit score when you know you'll soon need credit. Your credit score will reflect good spending and budgeting behaviors. Are you getting ready to make a big purchase, such as a home or car? At least a few months in advance, have a look at your credit score. While the score that you get through your bank or a service may not be the exact same one your lender uses, it will grade you on many of the same criteria and give you a good indication of how well you're managing your credit. It will provide you with specific ways to improve your credit score in the form of several codes or factors that kept your score from being higher. Another smart move is to regularly check your credit reports. You're entitled to one of each of your three credit bureau reports (Equifax, Experian and TransUnion) for free every 12 months through AnnualCreditReport.com. It's smart to stagger them. Send for one every four months, and you can monitor your credit for free.

THE IMPORTANCE OF GOOD CREDIT

If you're like most people, you want a nice house, vehicle, good paying job, you know… good quality of life. However, most of us can't afford to fork up the cash on the front end and pay for these things at once. So, we rely on credit in order to obtain these high priced items. Although there are a ton of reasons why maintaining good credit is important, here are the main reasons:

First, having good credit is essential when trying to get the best rate on financing just about anything. For example, a $20,000 vehicle loan for 5 year at a 3% interest rate is about $360 a month for payment. However, that same vehicle loan with a 10% interest rate is about $507. That's $147 a month difference due to having bad credit! This may not seem like much, but over 5 years this amounts to $8,820! As you can see, just simply maintaining good credit can save you money over the long haul.

Credit can really become important when attempting to get a mortgage loan or even attempting to rent an apartment. Having good or poor credit can be the difference in staying in a good neighborhood or poor neighborhood, as some lenders won't issue loans to individuals with poor credit in well-established neighborhoods. Even apartment complexes will run a credit check to allow residency. Needless to say, those with poor credit are more accepted in poverty and crime-stricken areas than suburban areas. That's right, something as simple as having good credit can shape you and your family's standard of living as well as your life.

Speaking of life, having a good paying job is important to having a good quality of life, right? Absolutely! However, did you know businesses today are doing credit checks on employees to determine whether or not the person fits the job? That's right, that student loan you've been ignoring could come back to haunt you during your job search! Any bankruptcies or garnished accounts are considered red flags to future employers. So, don't let this be you, make sure you stay abreast of your credit score and pay YOUR BILLS ON TIME!

DO'S AND DON'TS OF HANDLING CREDIT RESPONSIBLY

DO'S

1. Pay all your bills on time. Your payment history makes up 35% of your credit score.
2. If you need to close accounts, close store credit cards only if they are not your oldest. Store cards have low credit limits. If the limit is $500 and you're at $300 then you are over 30% utilization.
3. Be conservative with your credit cards and stay under 30% utilization.
4. If possible, set up alerts for updates on your credit score.
5. Set up auto pay for your creditors.
6. If possible, call your lenders to get a credit increase. Credit increase lowers you utilization and raises your score.
7. Call and ask for an interest rate decrease. Lower interest rates will help you pay your loan off quicker.
8. Protect yourself from identity theft and fraud.
9. View your credit report quarterly to stay on top of any false activity.
10. Request a copy of your report a month before a major purchase.
11. Create a plan to pay off your debt.

DON'TS

1. Try not to close any accounts before applying for a loan. The higher your credit utilization, the better.
2. Keep your older accounts open. Part of the formula is how long you've had the accounts.
3. Be careful not to open multiple accounts. New credits inquiries can lower your score 2-20 points.
4. Don't pay less than your minimum payments.
5. Don't neglect bills that don't report to credit bureaus. Delinquent accounts can be reported to credit bureaus.