Assume the Role of Managing Your Credit Prudently and Watch Your Credit Score Improve

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OVERVIEW

The three numbers that make up a credit score have become an obsession to some people. But what's really important is how you manage your credit.

Most credit score models are simply a measure of the likelihood that you will default on a loan payment, which is defined as being more than 90 days delinquent or "past due."

Lenders use your credit score in conjunction with other criteria to help determine whether to approve you for credit, ranging from a mortgage to a credit card, and what interest rate and terms to offer you. In addition, other businesses—including utilities, landlords and more—may check your credit score to see if you are likely to pay your bills to them.

In reality, your credit score is simply an interpretation of the information in your credit files—a fact that sometimes gets lost when people focus too much on the ups and downs of their score—letting their credit score determine their credit behaviors rather than vice versa. The purpose of this paper is to help you make good decisions and manage credit wisely. If you do that, you can leave your credit score on autopilot until you actually need credit. The key is to understand the bigger picture. Every time you use credit, you have an impact on your credit files, whether you are paying for groceries with your credit card or taking advantage of interest-free financing on your living room furniture.

It's critical to understand that each person's credit history is completely unique, so the impact of the decisions you make when handling your credit is unique to you. That's why it is so important to be your own credit manager and focus on making prudent decisions based on your own financial situation.

Understanding that everyone's situation is unique, let's take a look at two common consumer questions:

- How can I improve my credit score?
- How do certain credit-related activities affect my credit score?

Before we can answer those questions, though, it is important to understand some basics.

CREDIT FILES AND THEIR RELATIONSHIP TO CREDIT SCORES

Even the financial gurus on television often make the mistake of not differentiating between **credit scores** and **credit files**. Your **credit file** contains the information about your credit-related activity that lenders report, such as auto loan and mortgage payments, credit card payments and balances as well as credit inquiries, among other activity. This information also might include public records, such as tax liens and other information from government sources. The credit files are maintained by the three national credit reporting companies (CRCs): Equifax, Experian and TransUnion. Most lenders report activity to some or all three of the CRCs each month. Another term you may have heard, **credit reports**, are a compilation of the credit files. You can receive a free copy of your credit report from each CRC once a year by visiting www.annualcreditreport.com.

Your **credit score** is a three-digit number derived from a mathematical interpretation of the information in your credit files. Credit score models, such as the VantageScore® model, use the information in your credit files to arrive at your credit score.

Lenders and other institutions typically use a VantageScore credit score or other credit score—along with information they obtain directly from your actual application, such as income, total monthly debt payments, down payments and employment status—to make decisions. Together, the information helps a lender determine the terms of a loan, which can affect the amount you might pay in interest and finance charges. A higher VantageScore credit score indicates a lower likelihood of risk to lenders, so if you have a higher credit score, you generally can get credit at more competitive rates than you could if your score was lower.

DO CREDIT SCORES CHANGE OFTEN?

The short answer is yes, credit scores do change often.

Your credit score probably will be different each time it's obtained because the information in your credit files has most likely changed since the last time your score was requested. The information in your credit files changes when a lender provides an update on the status of one of your credit accounts, such as whether you have made payments on time, how much credit you've used, and how much credit you have left.

For example, your credit score goes up as you make on-time payments on a loan or reduce the balance on a credit card. Your score goes down when you make a late payment or increase the balance on your credit cards. Your credit score also changes when you apply for additional credit, take out a new loan or experience a charge-off[1], foreclosure or bankruptcy.

In theory, if you have 10 accounts in your credit files, your score might change 10 times a month if a score is pulled after each single account is reported. There are roughly 200 million consumers with credit files in the United States, and approximately 36 billion pieces of credit data are recorded on their credit files every year. That's an average of more than 15 changes to a credit file each month for each consumer. The impact that the information in your credit files has on your credit scores changes over time as well. Negative information may become less impactful over time.[2]

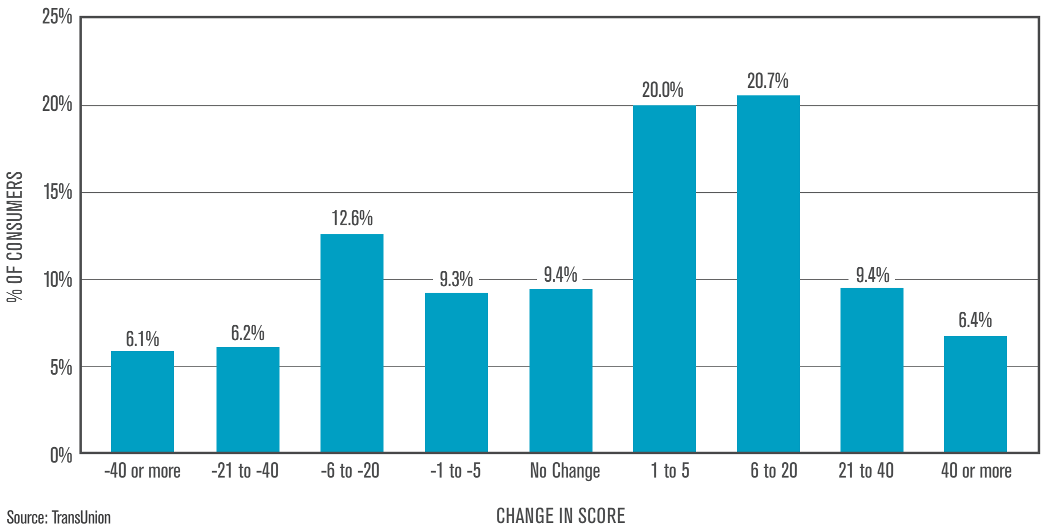
Don't be alarmed by this. It's entirely healthy and routine for your credit scores to change slightly.

1 A "charge-off" occurs when a lender, generally for tax purposes, declares that an amount of debt is unlikely to be collected, which can happen when a consumer becomes severely delinquent on a debt. The lender reports to the CRCs it has taken a loss, but the consumer is still responsible for paying back the debt.
2 More information about how the impact of certain credit activities changes over time is discussed later in this paper.

HOW MUCH DO SCORES CHANGE?

Roughly 70% of credit scores change by up to 20 points in any given 90-day window. A 20-point change isn't very significant most of the time; a 40-point drop is more of a concern. As you can see in Figure 1 below, most consumers experience a score improvement rather than a score drop. In fact, 56% of credit scores shift higher, while 34% drop, and the remaining 10% stay the same. Of those that experience a score drop, 6% see a drop of more than 40 points. For these consumers, it's important they take steps to repair their credit profiles, which is entirely possible over time as you'll see as you read further.

FIGURE 1
HOW SCORES CAN CHANGE OVER A 90-DAY PERIOD



Source: TransUnion

Higher credit scores always improve your likelihood of obtaining good credit terms. Of course, sometimes even a small credit score drop can be detrimental. For example, if your VantageScore credit score is 700[3], but the minimum required score for a loan with a particular lender is 705, then there is a chance that you will not qualify for good credit terms without appealing directly to your lender or loan officer.

The good news is that with simple credit management techniques, you can typically improve your credit score by 10 to 15 points within a few months. For larger score improvements of 40 or more points, you may need to demonstrate disciplined credit management over a longer time frame.

[3] There are many credit score models used by lenders, including the VantageScore model. Not all models use the same score range. The VantageScore range is from 501 to 990.

WHY DO SCORES CHANGE?

As mentioned, most adults in the United States have a consumer credit file at one or more of the CRCs. Lenders report behavior about each credit account on a monthly basis to one or more of the CRCs.

The impact on your credit score from each single credit activity appearing in your credit files varies, but there are generally things that have good or bad consequences. Figure 2 below explains how some credit-related actions and events generally impact credit scores.

FIGURE 2
IMPACT OF VARIOUS ACTIONS ON CREDIT SCORES

ACTION	LENDER INTERPRETATION	SCORE IMPACT
Pays bill on time	Wisely handling debt	Improvement
Uses small portion of credit limits	Sufficient access to credit, unlikely to need additional funds	Improvement
Mature accounts	Experienced credit user	Improvement
Uses diverse range of loan products	Experience with different types of repayment requirements	Improvement
Inquiry about new loan	Why the need for credit–exposure or normal expansion?	Small drop
Opens a new loan	Why the need for credit–exposure or normal expansion?	Small drop
New accounts	Will consumer effectively manage new credit?	Small drop
Maxes out credit card (At/near credit limits)	Tipping point: potential for significant exposure	Drop
Pays late–first time	Tipping point: potential for significant exposure	Drop
Pays multiple loans late	All credit at risk	Larger drop
Misses multiple payments on a loan (3 or more)	All credit at risk	Larger drop
Charge-off	Default	Major score drop
Foreclosure	Default	Major score drop
Bankruptcy	Default	Maximum score drop, extended time impact

LOW RISK

HIGH RISK

The actions shaded green for "low risk," which include paying bills on time and using a number of different types of loans, obviously signal that you are handling your credit wisely. The actions in the red-shaded risk areas, which include paying multiple loans late and declaring bankruptcy, signal that you are having problems making payments on time.

The activities in the yellow-shaded risk area can be entirely appropriate but still can cause your credit score to drop slightly. This is because the millions of transactions and past consumer behaviors used to create and test credit score models demonstrate that consumers with these actions appearing recently in their credit files are riskier; when risk increases, scores drop. But the score drops are minimal for the actions in the yellow area.

The small drop caused by the activities in the yellow area can be made up very quickly. For example, your score might go down slightly because an inquiry[4] was reported to the CRCs and you opened a new credit account, but if the CRCs are notified that your payments for the new account are on time and your balance is not excessive, your score begins to benefit from the positive information created as a result of the new credit account.

[4] Most credit score models accommodate the need for consumers to shop for the best interest rate for a single loan by inquiring with multiple lenders. The VantageScore model interprets all inquiries within a 14-day window as a single inquiry. This is discussed in more detail later in this paper.

WHY DO SCORES CHANGE?

(Cont.)

Information, especially negative information, doesn't stay in your credit files forever. Both positive and negative information reported by lenders drops off the file after a set period of time; the only negative item that remains in your credit files indefinitely is a tax lien. Other items disappear at different rates. The table in Figure 3 provides the length of time that certain types of negative credit information generally remain in your credit files:

FIGURE 3
LENGTH OF TIME NEGATIVE INFORMATION GENERALLY REMAINS IN YOUR CREDIT FILE

Chapter 7 Bankruptcies	10 Years
Late Payments	7 Years
Foreclosures	7 Years
Chapter 13 Bankruptcies	7 Years
Collections	7 Years
Public Record [5]	7 Years

But if one of these negative items has happened to you, don't give up hope! Even though these items will stay in your credit files for the length of time indicated in Figure 3 above, they are not calculated in your credit score for the entire time they are in your files. Moreover, the impact these items will have on your credit score may diminish over time. In other words, although a late payment stays in your credit files for seven years, it does not continue to drive down your credit score for the entire period. It is even possible to repair your credit score after a bankruptcy. This is because a credit score can and will change as the information in credit files becomes older and less impactful. In other words, information is weighted less by credit scoring models as it ages.

Here's what you need to know about negative information in your credit files:

1. So long as additional negative information isn't added to your credit files, the negative impact of all of these events on your credit score diminishes with each passing month from the time the event occurred.

2. Your score will experience the greatest drop in the first month after the negative event.

3. As time goes by, the event will have less and less impact until at some point it has no impact whatsoever, even though the timeframe for which the event remains in your file hasn't ended. Typically after two years, most negative items have little impact on your credit score.

4. Of all these events, bankruptcies and public records have the biggest impact on your credit score, causing the largest drops and taking the longest recovery time.

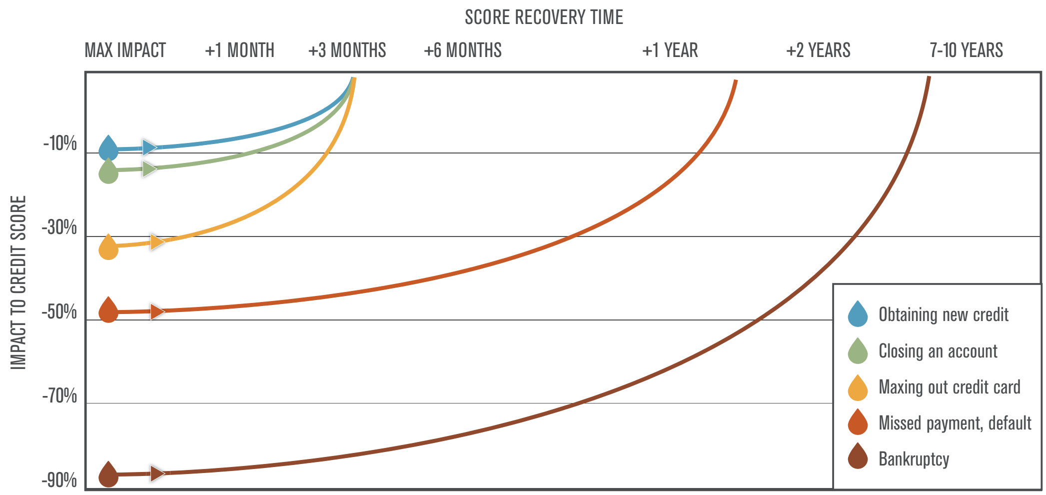
5. With ongoing, good credit management, your credit score will improve and offset these events.

[5] Public records include information filed or recorded by local, state, federal or other government agencies that is available to the general public. The types of public records that can affect your credit score include judgments against you from bill collectors or in small claims court, or tax liens levied by a government authority.

WHY DO SCORES CHANGE?
(Cont.)

To illustrate this, Figure 4 below tracks how five credit management activities can impact a credit score over the course of a two-year period.

FIGURE 4
RECOVERING FROM AN ACTION THAT CAUSED YOUR SCORE TO DROP



Of course, proactively managing your credit means you avoid missed payments or any of the other negative actions. But if those kinds of events do occur, you need to become "current," which means that you've caught up on all missed payments. Once you are current, the impact diminishes over time as the benefits of making payments on time cause your credit score to improve.

WHAT CREDIT SCORE CHANGES CAN YOU EXPECT FROM TYPICAL CREDIT MANAGEMENT ACTIVITIES?

This question gets to the heart of what is on the minds of many consumers. To illustrate how typical credit management behaviors can impact credit scores, consider the profiles of two typical yet hypothetical consumers.

Let's call the first consumer Janet. She has high credit quality with a VantageScore credit score of 900, and she manages her credit in a prudent and consistent manner. She probably never has made a late payment and keeps her credit card balances low.

Let's call the other consumer James. He has average credit quality with a VantageScore of 760. James might have missed a few payments, and his credit card balances are high. He would benefit financially if he managed his credit differently.

Next, let's see how some credit-related activities might impact their credit scores.

Figure 5 below shows the impact that some common actions or occurrences might have on Janet's and James' credit scores. Again, it's important to understand that the precise impact on a consumer's score depends on the specific information in his or her credit files. In fact, you will see that some credit actions have a greater negative impact on Janet's credit score than James'. That's because the impact that negative items, such as a missed payment, are greater on their first occurrence. The credit score for a person like James who previously missed a number of payments will have already experienced the "first-time" impact.
With that in mind, let's look at a range of possible score changes for each credit management activity, rather than an exact level of score improvement or drop.

FIGURE 5
IMPACT OF ACTIONS ON TWO CREDIT SCORE SCENARIOS

SCENARIO		Starting Score	
		High Score	Medium Score
		900	760
MISSED PAYMENTS		**SCORE DROP RANGE**	
Bankcard	30 days	70 - 90	60 - 80
	60 days	85 - 105	70 - 90
Auto	30 days	80 - 100	60 - 80
	60 days	100 - 120	70 - 90
Mortgage	30 days	80 - 100	60 - 80
	60 days	100 - 120	70 - 90
Charge-off or Foreclosure		130 - 170	80 - 110
Charge-off, placed at collections agency		165 - 185	105 - 125
Filing bankruptcy		350+	200+

WHAT CREDIT SCORE CHANGES CAN YOU EXPECT FROM TYPICAL CREDIT MANAGEMENT ACTIVITIES?

(Cont.)

For Janet, being 30 days late on a credit card payment can lower her credit score by 70 to 90 points because it's her first delinquency. Being an additional 30 days late lowers her credit score by an additional 15 points to make the total impact of being 60 days late between 85 and 105 points. Because James' credit score is already substantially low, his original score of 760 is reduced by 60 to 80 points if he is 60 days late, which puts him among consumers who are considered very high risk.

Tips:

- The first missed payment has the largest impact on a credit score. Nevertheless, additional missed payments will continue to drive your score down and make it more difficult to become current. So if you've missed a payment, try to become current again before your next payment is due.

- For most credit score models, missing a credit card payment has less impact than missing a mortgage or auto payment. This is because credit score models consider late payments on your larger, secured debts as higher risk than being late on smaller, unsecured debts such as credit cards.

	Starting Score	
	High Score	Medium Score
SCENARIO	900	760
OBTAINING CREDIT	SCORE DROP RANGE	
Making an inquiry	10 - 20	10 - 20
Opening a new credit card (additional)	0 - 5	0 - 5
Opening a new mortgage (additional)	0 - 15	0 - 15
Opening a new auto loan (additional)	0 - 15	0 - 15

If a lender runs a credit check and obtains a credit score for either Janet or James to determine their credit risk, an inquiry is reported to the CRCs, which could reduce their credit scores by 10 to 20 points.

Tips:

- You should apply for credit only when you need it. If you are approved for credit, the impact from making an inquiry will disappear within a short time and the score will quickly improve if you make on time payments.

- When you do shop for credit, do so within a short period of time. Credit score models take rate shopping, (e.g., for a mortgage or car loan within a 14-day window) into consideration, so if you're seeking credit and if multiple lenders obtain your credit score, their inquiries typically are interpreted only as a single inquiry.[6]

[6] The window of time that credit score models use to account for rate shopping varies. The VantageScore model interprets all inquiries within a 14-day window as a single inquiry.

WHAT CREDIT SCORE CHANGES CAN YOU EXPECT FROM TYPICAL CREDIT MANAGEMENT ACTIVITIES?

(Cont.)

	Starting Score	
	High Score	Medium Score
SCENARIO	900	760
USING CREDIT CARDS	SCORE DROP RANGE	
Using all available credit on one credit card	90 - 110	55 - 75
Spreading credit usage over multiple credit cards	60 - 80	30 - 50
Closing an old credit card account	10 - 25	15 - 30

If Janet uses up the entire balance of her credit card, it causes her score to drop by 90 to 110 points. Because James' credit score is lower, the impact is less severe, but his score still drops.

Tips:

- If you must keep a balance on your credit cards, it's best to spread the total credit card balance across multiple credit cards rather than maxing out a single card. Several small balances have less impact on your credit score than a single high balance.

- Reducing your credit card balance from 50% to 30% of the total credit available on that card can improve your score by as much as 50 points.

	Starting Score	
	High Score	Medium Score
SCENARIO	900	760
SCORE IMPROVEMENTS	SCORE INCREASE RANGE	
Paying down the mortgage by $25,000	10 - 20	15 - 25
Accounts age by one year	1 - 3	1 - 3
Reducing credit card usage to 50% - 30% of limit	30 - 50	20 - 40

For Janet and James, reducing credit card balances and paying down mortgages can improve their scores by as much as 50 points.

Tips:

- The easiest way to quickly improve your credit score by 10 to 20 points may be to reduce credit card balances substantially and to maintain the behavior for a couple of months.

- Paying down the mortgage by $25,000, for example, may improve a credit score by as much as 25 points.

- Rather than closing older, unused credit cards or other credit accounts, allowing them to remain on a credit file can help improve your score by several points each year.

HOW CAN YOU IMPROVE YOUR CREDIT SCORES?

Remember, specific credit-related activities impact your credit score differently than they impact another consumer's credit score because your credit file is different from everyone else's. Generally speaking though, there are proven ways to improve scores.

Consider the cases of four hypothetical consumers. Based on each credit profile, there are things that each person can do which may (or has been shown to) improve his or her credit score.

Consider these profiles:

BILL: A HIGH CREDIT QUALITY CONSUMER (SCORE GREATER THAN 850)

Bill's Profile:

- He makes payments on time.
- He has many types of credit (e.g., credit card, mortgage, auto loans).
- He has managed credit wisely for many years.

Ways to improve his score:

- Substantially reduce the total percentage used on each credit card by reducing the balances on the cards.
- Make additional mortgage payments to reduce the remaining loan amount.
- Maintain these two strategies for at least three months.

With a credit score as high as Bill's, he probably already has been given the best rates and terms, so improving his score probably won't improve the terms and offers from lenders.

BRENDA: AN AVERAGE CREDIT QUALITY CONSUMER (SCORE BETWEEN 650 AND 700)

Brenda's profile:

- She missed some payments, possibly on major loans such as mortgage or auto.
- She uses many types of credit (e.g., credit card, mortgage, auto loans).

Ways to improve her credit score:

- Ensure payments are made on-time for at least six months, preferably a year.
- Ensure that all existing missed payments do not become more than 30 days late.
- If the balance amount on one or more credit cards is greater than 70% of the full credit line for that card, reduce balances to less than 30% and maintain that level for at least six months.
- Maintain these steps for at least six months.

Brenda may be on the cusp of getting a loan or qualifying for the best interest rate and terms for a loan. She could benefit from a short-term increase of 10 to 15 points in her credit score and from the longer-term credit score increases that would result from maintaining good credit management for an extended period of time.

HOW CAN YOU IMPROVE YOUR CREDIT SCORES?
(Cont.)

JENNIFER: AN INFREQUENT CREDIT USER (SCORE BETWEEN 600 AND 650)

Jennifer's profile:
- She has two or fewer active accounts.
- She has very few missed payments, and her credit accounts are the same type of credit.

Ways to improve her credit score:
- Keep all accounts current for at least 12 months, preferably 18 months.
- If the balance amount on one or more credit cards is greater than 70% of the full credit line for the card, reduce balances to less than 30% and maintain that level for at least six months.
- Do not make inquiries for new credit or open any new accounts.
- Maintain these steps for at least 12 months.

Jennifer needs to demonstrate good credit management for a prolonged time period. She should not seek credit until her credit files have more positive information. By concentrating on the information in her files and ensuring that only positive information is reported to the CRCs, she will see that her score has improved when she is ready to seek credit again.

MIKE: PREVIOUS BANKRUPTCY (SCORE BETWEEN 575 AND 625)

Mike's profile:
- Declared bankruptcy three years ago.
- Public record remains on credit file for at least seven years.

Ways to improve his credit score:
- Keep all accounts current.
- If payments are missed, keep the size of missed payments as small as possible.
- Maintain low balances on all accounts (less than 30% of the full credit line), especially credit card balances and installment loans.
- Do not make inquiries for new credit or open a new account.
- Maintain these steps for at least 18 months.

Mike obviously needs to spend time recovering his credit score because declaring bankruptcy is a significant, negative credit event. Before providing him with new credit, lenders will want to see that Mike will not become over-extended again.

As you can see, it is entirely possible for Bill, Brenda, Jennifer and Mike to improve their scores using a variety of good credit management practices ranging from reducing the balances on their credit cards to not missing payments or needlessly seeking credit.

The **key** to improving a credit score or maintaining a good score is to practice these behaviors for a period of time—or better yet, indefinitely. The more evidence of wise credit management in your credit files, the more your credit score improves over time. You also should plan ahead. If you need to finance the purchase of a car or if you plan to acquire significant levels of credit in the future, keep your credit card balances low. Don't apply for unnecessary credit and cause inquiries to be reported to your credit files. It's in the months and weeks before you plan to apply for a loan that your credit management activities enable you to get the best terms for the loan.

FINAL THOUGHTS

Having a good credit score is extremely important, but worrying about whether it goes up and down slightly is much less important than paying attention to the information in your credit files, which is the result of how you manage your credit behavior. By practicing good credit management, you can ensure that your credit files are full of positive information that will keep your credit score high or reduce the behavior that is affecting your credit score negatively.

Manage your credit wisely and your credit score will take care of itself.