



Understanding Credit

When used properly, credit is a helpful financial tool. For example, using credit to purchase a home now, rather than trying to save up the whole purchase price, makes financial sense. The home provides a place to live that will perhaps increase in value and the mortgage interest offers a tax deduction. Credit may also help you deal promptly with costly emergencies. Many consumers turn to credit when faced with unexpected home or auto repairs, as well as medical emergencies. And credit offers convenience, enabling you to rent a car or hotel room or buy airline tickets over the phone. In many situations, credit offers peace of mind; there is no need to carry large amounts of cash when shopping or traveling.

Using credit wisely will enable you to establish a positive payment history and will favorably affect both the availability and cost of future credit including car loans, mortgages, credit cards, and personal loans. Your credit standing will also affect your insurance cost, employment opportunities, and housing options.

Your Credit Report

In the United States there are three major credit bureaus, Experian, TransUnion, and Equifax. These credit bureaus acquire data from creditors and search court and county records for lawsuits, judgments, liens, and bankruptcy filings. This information is compiled along with personal information and provided to creditors, insurance companies, employers, landlords, or anyone else who has a legitimate business use for the information, at their request.

Typically, your credit report will contain your name and any former names or aliases. It also reports your address and former addresses, employment history, and changes in marital status. The bulk of your credit report provides information on your credit history. Most creditors and their account numbers are reported along with information about the date the account was opened, the credit limit or original balance, whether anyone else is named on the account, the balance, and the payment pattern for the last 24 to 36 months.

How Long Information Can Be Reported

Credit reports may reflect lawsuits, judgments, liens, foreclosures, Chapter 13 bankruptcy, late payments, or any other negative information for seven years from the time it was reported. If you have filed Chapter 13 bankruptcy, the seven-year period begins on the date of filing. For charged-off accounts in collection agencies, the period starts the date the account was written off by the original creditor and sent to the collection agency. Judgments, if not paid, can be renewed until they are satisfied. A Chapter 7 bankruptcy will remain on a credit report for ten years from the date of filing.

Inquiries, an indication that your credit report has been accessed for a credit, insurance, or employment application, are reflected on your credit report for two years.

These timelines do not apply to positive credit information. Any accounts that have been consistently paid on time, or that were paid in full as agreed may be reported indefinitely. Having this kind of long-term positive information on your report reflects well on you as a credit risk.

Your Credit Score

A credit score is one of several factors lenders use when evaluating an application for credit – and is frequently the most significant one. A score is determined only by the information in a credit report that is predictive of future credit performance.

Fair, Isaac and Company developed the most commonly used score. Called a FICO score, it ranges from 300 to 850, with a higher number being indicative of less risk. Generally, those with higher scores are more easily granted credit and often have more favorable interest rates made available to them. Though each of the three major credit bureaus uses this system, it is sometimes called a Beacon or Empirica score.

There are many categories of credit information used to determine your FICO score, though some are much more significant in their impact than others:

- *Payment History = 35 Percent* – Bankruptcies, judgments, and collection accounts are major factors in lowering your credit score. Late payments can have a serious impact as well, particularly if the lateness was frequent, recent, or severe. The more times the account fell delinquent, the greater the effect the delinquencies will have on the score. Similarly, if the delinquencies were recent or severe – 90 or 120 days late as compared to 30 days – the score will be impacted more dramatically.
- *Amounts Owed = 30 Percent* – The amount of outstanding debt you have has a strong impact on your credit score. Carrying high balances, especially if those balances are close to the credit limit, can lower your score.
- *Length of Credit History = 15 Percent* – Accounts that you've had for more than two years will have a more positive impact on your score than newer accounts. This can be a challenge to consumers who take advantage of "teaser rate" accounts to repay debt. While constantly transferring balances to reap the benefits of short-term low interest rates can be a tool to repay debt efficiently, the constant influx of new accounts can be detrimental to your score.
- *New Credit = 10 Percent* – The number of new accounts may impact your score. Also, frequent

credit applications resulting in many inquiries on your report can lower your score. Accessing your own report periodically is not damaging to your score, as consumer inquiries are not taken into account for scoring purposes. “Pre-approved” offers do not impact your score either. Those are just offers made based on your name showing up on a list of consumers with certain criteria that a creditor may purchase from a credit bureau. It will not result in an inquiry unless you actually apply for the account. Employment inquiries will also have no impact on your score.

- *Types of Credit Used = 10 Percent* – The different kinds of credit accounts you have and use affect your credit score as well. By demonstrating that you can handle a variety of credit instruments (such as credit cards, retail accounts, installment loans, a mortgage, and consumer finance accounts) you are proving to a potential lender that you are capable of handling the different responsibilities that come with each debt type.

Your credit score constantly changes with your credit activity. It reflects payment patterns with greater emphasis on recent events. While there is no standard for what constitutes a “good” credit score, one benchmark to keep in mind is that most mortgage lenders look for a score of at least 620.

Improving Your Credit Report and Your Credit Score

While it is not possible to remove accurate negative information before the time it drops off the report, you can improve your score by using credit responsibly:

- *Pay on time, every time* – A commitment to never make a credit payment late again is one of the most powerful steps you can take to improve your credit rating.
- *Reduce your debt load* – Even if you have never missed or been late with a payment, excessive debt will lower your score. Develop a plan to reduce it. For assistance, contact your credit union. They can provide you access to services that can help you set up an effective spending and savings plan, and determine options for efficient debt repayment.
- *Pay collection accounts* – If you have collection accounts on your credit report, you can give your score a quick boost by paying them. Request payment arrangements for balances you can’t afford to pay in full (make sure you confirm the agreement in writing).
- *Limit open accounts* – Two to four open unsecured credit accounts is usually perceived as a good number to have. Having too much available credit can make you appear risky to a lender. You may have no or low balances today, but could easily be deeply in debt tomorrow if you chose to go on a spending spree.
- *Keep your old accounts* – Accounts that you’ve held for two years or more show credit history, which indicates stability. Creditors only have limited information to base decisions on with new accounts.
- *Avoid “maxing out” accounts* – Keep your balances no more than 60 percent of the limit on revolving credit. High balance-to-limit ratios represent higher risk because it gives the impression that you are applying for new credit to take the place of the “maxed out” account.
- *Avoid balance transfers* – While transferring balances to “teaser rate” cards can be a way to efficiently get out of debt, it can have a detrimental effect on your credit score. The accounts will

be new, and likely have balances close to the limit in order to maximize the advantage of the low rate – two factors that can lower your score. However, if your goal is to get out of debt, a lower interest rate will help you repay balances faster and for less money.

- *Avoid excess credit applications* – Each time you apply for credit, your score decreases just a bit. Too many applications can be damaging, so only seek loans and credit you truly need.

Establishing or Re-establishing Credit

Whether you have no credit score because you've never had credit, or your score is low because of past problems, there are steps you can take to establish and re-establish credit.

A good option for many people is a secured credit card. Some financial institutions will issue you a credit card if you put a specified dollar amount on deposit with them. These funds are held as security, and a credit card is issued with a line of credit equal to the amount you have on deposit. If you make payments as agreed for approximately one year, the creditor may release the funds held as security and issue an unsecured card.

Another option is asking a friend or family member who has a good credit history to cosign on a loan or credit card for you. Be especially careful with these arrangements though – any late payments you make will not only reflect poorly on your credit report, but your cosigner's as well. After six months to a year, reapply for credit on your own.

Beware Credit Repair

Some companies claim to “repair” consumers' credit reports – often for a very high fee. They frequently operate by flooding the credit bureaus with letters that dispute negative, but accurate, information. If the credit bureau is unable to investigate the claim within 30 days, the information is removed. This rarely works though – the credit bureaus are generally able to respond in time, and even if the information is removed due to a backlog of requests, it will simply be re-reported by the creditor later.

Another common tactic credit repair agencies use is to issue consumers a “new identity,” complete with a tax identification number to use as a social security number. This is an illegal practice for which the consumer often ends up paying the legal price.

Remember, there is no legal way to remove accurate and timely information from your credit report.

Money Management and the Wise Use of Credit

With credit being so available and so convenient, it can be easy to get in over your head. Overextension gets thousands of consumers into financial trouble every year. Designing a realistic spending plan will help you determine how much credit you can afford- and will safeguard against using credit to supplement your income.

Tracking Where it Goes

One of the most important steps in establishing a money management plan is to gain an accurate understanding of where your money goes every month. Ever wonder how the \$40 ATM “fast cash” disappeared so quickly – and you can’t remember where you spent it? An accurate budget depends on being aware of every purchase you make.

There are several good methods you can use to track spending. However, when you begin the process, try to spend as you normally would. You will make adjustments based on your discoveries later.

- *Write it down* – Carry a small notebook with you and record every purchase you make. Jot down the date, item, and cost. Add up your daily spending. After several weeks of doing this, you will have a good idea of where and how you spend your cash.
- *Keep receipts* – Keeping receipts from each purchase you make and tallying them up at the end of the day is another method of tracking expenses. However, it won’t be absolutely accurate if you make purchases where no receipt is given, such as a newspaper or soda from a machine.
- *Use checks or debit cards* – Though, as with receipt keeping, you won’t get a perfect record of how you spend your money on a daily basis, using checks and debit cards are a good alternative to cash. With a check you have your checkbook register to keep track, with debit cards your financial institution provides either a written or online statement at the end of the month.
- *Monitor ATM use* – While keeping tabs on how much cash you extract from the ATM won’t help you with tracking purchases, it will help you become aware of how often you go and how quickly that cash gets spent. Become conscious of how frequently you go, and how much you take out before you have to revisit it.
- *Use a computer tracking program* – After you have tracked your expenses with the above methods, you are ready to plug the information you have gathered into a longer term tracking system. Computer programs can be very useful, as they allow you to have preset categories individualized for your lifestyle. But remember – these tools only work if you use them consistently.

Live Within Your Means

The concept of living within your means may seem like simple common sense, all you need to do is not spend more than you make, right? For many of us, though, the reality is much more challenging than this basic concept. If your expenses exceed your income, you charge more each month than you pay off, or you’re not saving toward your goals, you are, in fact, living beyond your means – and cheating yourself out of making the most of your money. Don’t let this get you down, though. There are ways to take action and gain control of your finances.

You may have a few options for increasing your income. Working overtime, getting a part-time job, a better paying job or applying for a promotion are great ways to bring in more money. Selling assets can bring in lump sums that can be used for eliminating debt or applying to savings plans for future goals. If you decide to liquidate assets, be sure to find out if you will have any tax consequences or penalties for doing so.

Most of us have some expenses we can reduce or eliminate. Fixed living expenses are generally more difficult to adjust than discretionary expenses. However, if you are truly committed to your goals, a little creativity can go a long way. When it comes to your discretionary expenses, consider them carefully. Is there anything you currently spend money on that you can reduce, substitute, postpone or forego?

Delete Your Debt

If excessive debt is the issue that's throwing your budget out of whack, discipline and commitment are the keys to success. First, make a pact with yourself to live a cash-only lifestyle. Before you can reduce your balances, you need to stop increasing them. Close the accounts if you don't feel you can control yourself. If you keep an emergency credit card, don't carry it with you. Keep it in a secure place in your home.

There are two basic methods of effectively and efficiently repaying your debt. Increasing your payments will dramatically reduce the length of time, and thus the cost, of paying your creditors. Reducing interest rates will also save you repayment time and money. If your credit rating is good, requesting better rates from your lenders may work. Transferring balances to lower rate accounts is also effective. If you have equity in your home, converting high-interest credit card debt to low-interest secured debt is a tool to consider- and it may be tax deductible. Be sure you can handle the payments involved in this option as defaulting on a loan secured by your home can have dire consequences. If you do transfer balances to lower rate cards or secured debt, make sure you close the old accounts to keep from using them again.

The Cost of Credit

Balance	Interest Rate	Monthly Payment	Repayment Time	Total Cost
\$5000	18%	\$100	7 years 9 months	\$9311
\$5000	18%	\$150	3 years 10 months	\$6983
\$5000	10%	\$100	5 years 5 months	\$6495
\$5000	10%	\$150	3 years 3 months	\$5882

The chart above shows the cost of credit for a \$5,000 debt. At 18% interest, paying just \$100 each month, it will take almost eight years to pay off the balance and will cost almost twice the amount of the original debt.

Paying only \$50 more a month takes nearly four years off the repayment period and saves you thousands. Borrowing money at a lower interest rate cuts your costs even if you only pay \$100 a month, but again, paying just \$50 more the repayment time by over two years and saves you more than \$600.

If You Can't Make Payments

If you are unable to make the minimum payments on your bills, do not avoid your creditors. Be

proactive. Write a letter asking for their understanding of your situation. The creditor may offer a hardship or loan extension program, allowing you to make reduced payments temporarily. Your letter should include:

1. The reason you are unable to make your full payment (layoff, injury, divorce, etc.)
2. Your prospects for getting back on track (When do you expect to start a new job? When does your doctor say you'll be able to return to work?)
3. What you are proposing (Suggest to the creditor what you think is a reasonable amount to pay each month until you are able to resume full payments.)

When writing to your creditors, be realistic. Don't ever promise to send a payment that you are not absolutely sure you will be able to afford. Your creditors will be more willing to work with you if you are straightforward with them. Once you come to an agreement with your creditors, stick to it and keep the lines of communication open.

Repay Debt while Saving for Other Goals

If you have debt, you may be wondering if it is wise to repay it before or after starting a savings plan that is geared to reaching your other financial goals.

The answer is that you often can – and should – do both at the same time. Having an emergency fund will keep you from using credit for unexpected expenses. And by starting the fund now, even if all you can manage is \$10 per month, you will get a jump-start on establishing healthy money management habits.

Saving for retirement can also be a good idea even while you're repaying debt. Employer sponsored retirement plans, such as a 401(k) or 403 (b) plan, have many advantages that can help you maximize your dollars, both in the present and the future. If you do not contribute, you will miss out on such benefits as reducing your taxable income and letting pretax dollars collect interest. And since many employers match contributions up to a certain percentage, you lose free money by not taking advantage of the plan.