How Credit Cards Affect FICO Scores

Along with budgeting and responsible spending habits, understanding how credit cards affect FICO scores is important to your financial health. Credit scores are calculated using many different variables, one of which is the balance-to-limit ratio of your revolving credit accounts. To calculate your credit utilization, simply divide the balance of each card by its credit limit, then multiply by 100 to obtain a percentage.

Both the overall utilization of your cards (the total balances of all cards divided by the total credit limit) and that of individual cards are considered. If you have a high balance-to-limit ratio on some cards and a low ratio on others, transferring some of the higher balances to the low-utilization cards may help increase your scores, but the overall utilization has a bigger influence.

Leveling Up

While the precise ratios that trigger an increase or decrease are a closely guarded secret, in general, the lower your overall utilization of credit, the better. According to FICO, below 30% is good, but tests have shown that keeping it below 10% is ideal. Utilization higher than about 50% will significantly impact your scores. Utilization above 70-80% can effectively remove you from top-tier credit consideration by a lender—even if there are no late payments found on your credit reports. Credit tiers will differ among lenders, but a typical example goes something like this:

- 300-549 – Bad
- 550-619 – Poor
- 620-679 – Fair
- 680-739 – Good
- 740-850 – Excellent

Distributing Balances

If you urgently need to increase your scores, and they are currently high enough that they will enable you to qualify for another card, one option is to obtain a new card and use it to distribute the existing balances. Depending on the bank, this may also be an opportunity to take advantage of an interest-free period of significant duration. Keep in mind that the sudden addition of newly available credit to your reports, as well as the hard inquiry itself, can cause your scores to decrease slightly.

Please note that the above is a *terrible* idea if your problem stems from being unable to control your spending. Attempt this only if you have been able to consistently stick to a budget. The new card is not for *buying stuff* and should be put in a drawer or cut up and discarded, unless its benefits outweigh those of your other cards.

Score Hack: Small Balances

A little-known secret to playing the score game is the fact that they will *decrease* slightly when your cards have a zero balance, because carrying a small balance demonstrates that you are actively using and managing credit. Many online sources would have you believe this is a myth, but the major credit reporting agencies themselves have acknowledged it, and it's easy enough to test and confirm on your own.

The effect is significant enough that if your scores sit on the border between one credit tier and the next, it's worth keeping a very small balance on all your cards before applying for credit. This doesn't have to result in an interest charge, however, because the date your balance is sent to credit reporting agencies is not the same as the date interest charges are determined.

Banks will frequently charge a minimum fee if your balance is less than a particular threshold but still above zero. For example, 20% interest charged on a dollar amounts to less than two cents for the month, but your bank may instead charge $0.50 or $1.00. Avoiding this charge while still having a non-zero balance reported to credit bureaus is easy.

Because banks typically report balances on the statement date, which corresponds to the closing date of the billing cycle, if you utilize your cards at all and typically pay on the due date, you'll find that your statements will include a non-zero balance. As long as you pay the balance in full by the due date, you will not be charged interest.

The Automatic Credit-Building Machine

Once you've achieved scores worthy of envy, maintaining a constant zero balance will not affect your credit enough to matter. However, a credit card account that is never used will eventually be closed by the bank. You can avoid this simply by setting up automatic payments for a low-cost item you would be charging anyway, such as a streaming service, and paying the full balance of the card automatically every month as well.

Good Things Come to Those Who Wait

An important variable in determining credit scores is the length of credit history. As you may imagine, there is no shortcut here, and an improvement in scores from this variable can take many years. This becomes especially important if you don't generally use credit. Paying cash for most purchases, while in some ways admirable, can harm you when it comes to financing real estate. Mortgage lenders that have competitive rates *and* don't require a credit check do not exist. Having a credit card set to autopay is a free and effortless way to help build history, but it helps to have a variety of different types of credit accounts.

If you are a parent, an excellent way to kickstart your kids' credit history is to make them authorized users on one of your existing accounts. They will benefit from this whether you give them their own card to use or not.

The Long Haul

When you have the number of cards you want and are happy with their terms and awards, a good strategy for usage is to pick one (*maybe* two) that will be used for virtually all spending. While there are a few expenses that require an ACH link for withdrawal from your checking account, including mortgages, auto loans, and some home utilities, there are significant benefits to using a credit card for everything else:

1. Security. Debit cards simply do not offer the same level of buyer protection as credit cards.
2. Cash back. Ignoring the awards for purchases that may be unnecessary luxuries in life, such as restaurants and travel, if you spend (for example) $500 every month at Costco, using their card would result in 2% cash back in exchange for a year of shopping that you would be doing anyway. If you pay the card balance in full every month, that's $120 per year you wouldn't otherwise have.
3. Budgeting. The online credit card interface of many banks incorporates exceptional budgeting features that are not always available for checking accounts. Your spending will be grouped into categories ideal for tracking spending. Many budgeting apps also have links to this data available.

Conclusion

Along with budgeting and responsible spending habits, understanding credit utilization is vital. To sum up:

- Transferring balances strategically can improve scores, but keep in mind that this is a temporary emergency measure that doesn't solve the root of the problem.
- Utilize tools like automatic payments and debt payoff methods to manage balances effectively.
- Building credit history takes time, so start early.
- Leverage credit card awards and budgeting features.

With mindful management, you can navigate credit confidently and maximize its benefits.