Game Management

The Reasons You Need To Use Credit

There are some financial gurus and common people who say you should never use credit, and you especially should not use credit cards. Some people say this because they just do not want to owe anyone anything; others fear that they cannot manage credit. Many people fail miserably when managing the revolving credit extended to them. When it comes to owing people, we do not advocate maintaining debt that will result in paying interest unless it is good debt that provides a return.

Take the philosophy that non-credit users advocate. They maintain you should never use credit and should live off of your cash, which is your only buying power. Then, there is the disciplined credit philosophy. With either option, you must create and adhere to a monthly budget to make it work. An examination of the outcomes of the two philosophies is necessary to determine which one you should follow.

If you have no credit, your only means of paying for items is by using the cash you have on-hand or using what you have in a savings or investment account. In a pinch, you must have substantial savings or investments to cash in, or you may have to sell some asset to work through the situation. What about if you want to buy a house or new car? To qualify for an auto loan, you must have two trade lines that are 12 months old and three trade lines aged 24 months for a home mortgage. Both types of loans are trade line and score driven. Absent such a credit history, you must use buy-here pay-here or subprime lenders that have an extremely high interest rate. Many of these lenders do not report to the three NCRAs, so even if you come off the cash only philosophy to make these large purchases, you will not build credit. The end result of the cash only philosophy is that after six months without an active trade line, you have no FICO® score. Once 10 years passes without a trade line, you become a consumer ghost because there will be no credit report on you. The result is that you have no credit history, which makes you an extreme credit risk and subject to the highest interest rates. Cash is your only buying power under this philosophy.

Then, there is the disciplined credit philosophy. It requires optimizing your credit by being a transactor, which means that you are not paying interest on your credit cards because those bills are paid in full monthly. When you are in a pinch, you have the ability to use your credit to pay for whatever is needed to work through the situation without having a fire sale of your personal possessions or property. That desired new car or home is merely a matter of showing the creditor it is affordable under your budget, completing the paperwork, and making the down payment. Moreover, you will get the lowest interest rates as a result of your stellar credit history, which will save you thousands of dollars over the life of the loan. In the end, you have buying power beyond your cash.

Exercising the use of credit simply because it is available is not smart for anyone. In the end, the bill will become due and must be paid for in one way or another. You must use credit wisely or you will go bankrupt. Some people go bankrupt because they cannot live off of their cash alone, and when a personal sinkhole opens before them, they must sell off all of their assets because they have no credit. The point is that there is a choice to be made; the one you make and follow will have huge implications on your life. Having no credit is worse than having bad credit, for with bad credit there is a credit record and score. We know from experience that the disciplined credit philosophy we advocate creates wealth. It creates buying power due to lower interest rates. That buying power will allow you to capitalize on investment opportunities.

Earning and Maintaining a Top Tier Credit Score

If you have not taken an in-depth class on building a credit report to get a coveted credit score, you are most likely out of touch with what is required to build an above average score. It is more than just paying your bills on time. You must learn the meaning of, as well as practice, "Credit Optimization." This is, simply, using your credit in ways to assure it benefits you.

Understanding what factors into building a top tier credit score is essential to understanding the interplay between the fundamentals of the credit score game. Keep in mind that a credit score is calculated by analyzing *all* of the information on your CR. While singular factors have an impact on the score, it is the whole picture that creates the score. Due to the proprietary nature of the score models, what we present here are not exact factor percentages. This, however, is what FICO® says is the average percentages it applies to each area to calculate your credit score.

Time is an important statistical element of your credit score. It makes sense to say that the longer you know something about someone, the better you can judge what the future will bring when dealing with that person. Well, FICO® credit scoring models view it the same way. Length of credit history is 15% of your credit score. The next area is new credit; it is worth 10% of your score. Another 10% of your credit score is the mixture of different types of credit accounts. Payment history gives you a lot of points; it is worth 35% of your score. Finally, the amount of debt comprises 30% of your score.

Score Value	15%	10%	10%	35%	30%
Factor	Length of Credit History	New Credit	Mix of Credit	Payment History	Amount of Debt

Source: Fair Isaac Corporation

Understanding how these factors work is fundamental to optimizing your credit. Let's start with the **length of credit history** or the time factor. Time creates aged accounts, and time is your friend when it comes to positive trade lines, which is a credit account. The age factor begins with the oldest account on the report, which is recorded as the "date opened." This is the conception of your consumer report (CR). The age of specific accounts and the average age of all the accounts are considered. What do you think happens when you close an aged account, or if it vanishes after 10 years?

One of William's clients learned that answer the hard way. He was purchasing a large amount of investment real estate, and he sought to purchase another property. This client didn't show a large income on his tax return when considering the amount of assets he owned and his self-employment as a pilot. So, this client had to be financed with what is called stated income, stated asset. When assessing a client on stated income, stated asset, the first hurdle is the credit score. This client had a strong 753 score due to the charges he made through credit cards for fueling his plane. With a good score, the second hurdle to approval was due to it being a jumbo loan on an investment property, which required a 30% down payment. With an $850,000 purchase price, the client needed to put down $255,000.

The client had real estate assets of about $5 million with tax returns that showed $80,000 annual income. So, he refinanced one of his properties and cashed out $230,000. He said he would get the remaining $25,000 for the closing, but it was not until 55-days later that the client called to say he had the money to close the transaction. William restarted the loan process by obtaining a tri-merged credit report and found it changed substantively from just two months earlier. He called the client to ask how he obtained the $25,000.

He responded, "What I did was, I cash advanced my credit card and transferred it because another card offered me 0% interest for 12 months." The lender closed the account that the balance was transferred from, and it gave him only half the credit limit as that of the previous account. You might think this is not a real big deal, but what this client did was commit credit score suicide. A 12-year history on a $50,000 unsecured, revolving credit card closed! He then opened a new account with a maxed out balance. It was explained that his credit score dropped 75 points across the board and that it would take some time for his scores to come back up. The client was informed that he could start rebuilding his credit by paying that new card to a zero balance, using the $25,000 since he would not be closing on that property until he got his score back up. That is, unless he wanted to pay a higher interest rate and bigger down payment.

You should never close accounts that have time and payment history on your side. You also want to keep closed accounts on your CR even if there is something negative that will fall off after 7 years, such as a 30-day late payment on the trade line. You need that closed, aged history on your CR. The NCRAs collaborated with creditors to stimulate credit activity with the ten year rule. This is adverse to your interests. The removal of aged accounts changes the conception of your CR. The older your credit file, the more stable it is and the more credit worthy you appear. FICO® provides statistics from high credit score achievers, or game managers, who are winning the game. As to the length of credit history, those with the best credit scores have credit accounts that are 11 or more years old, and the oldest account, on average, is 25 years old. In other words, loyalty is key under FICO® scoring.

The area of **new credit** not only comprises 10% of your score, it sends a message about your financial stability to the credit world. It shows that you are able to pay off your debts and seek new credit for other items. That sends a signal that you are prospering and making growth. We want to periodically establish new installment accounts because we want to maintain loyalty to our creditors and establish the time factor with revolving accounts. We must, however, be careful here, for FICO® says, "Research shows that opening several accounts in a short period of time does represent great risk – especially for people who do not have a long established credit history."

FICO® says they consider the number, types, and time that has elapsed since a new account was opened. As new accounts start with inquiries, this factor also considers the number of inquiries and whether you are rate shopping. There are two types of inquiries. Soft inquiries are either when you request your CR and score or when a creditor does so without your authorization to offer you credit. These types of inquiries do not impact your score, and you are the only one to see them on a CR. Then, there are hard inquiries. These do have a score impact. They are when a creditor obtains your CR with a score for the purpose of making a decision of whether to approve credit.

According to FICO®, consumers with six or more hard inquiries on their CR are eight times more likely to declare bankruptcy than consumers with no inquiries on their CR. It is not uncommon for consumers to rate shop for a vehicle or home, which results in the dealer or creditor obtaining their CR and score. Several hard inquiries in a 45-day period for a car loan, for instance, will not result in a severe score hit because same purpose inquiries in that time period count as one inquiry. Inquiries made within 30-days prior to scoring are not counted in the calculation. Still, there is a way to limit credit approval to one inquiry. We touch on that momentarily. For score and appearance sake, we advocate limiting inquiries. Game managers have opened an account, on average, 2 years and 5 months ago. Less than 35% of them have applied for credit once or more in the past year.

Another factor in score calculation is the 10% for the **credit mixture**. Most important to your credit score is having three to six trade lines with a mixture of credit accounts. Credit cards, charge cards, and home equity lines of credit are called revolving accounts because they never end and the credit line remains open so long as it is under the credit limit. Auto loans and mortgages are examples of installment accounts. FICO® considers your mixture of credit cards, retail accounts, installment loans, and mortgage loans. A blend of revolving and installment accounts earns you more points. While the credit mixture is only 10%, it “will be more important if your credit report doesn’t have a lot of other information to base a FICO® Score on," FICO® says.

The largest factor is your **payment history**. This is where the spikes meet the clay. In baseball, cheaters use substances to build their bodies or apply it to the equipment. Eventually, it becomes apparent and penalties ensue. In the credit score game, if you cheat the game, you will eventually fall late on payments, become delinquent, and maybe enter into collections or bankruptcy. With 35% of your credit score based on payment history, it is essential to become a game manager to assure your CR does not suffer a delinquency black mark that results in a loss of credit score points. FICO® puts items that cast you in a "negative or unfavorable light" into the equation of a score calculation, and the resulting drop from such negative items has a dramatic and immediate impact upon a credit score.

	Score Impact Range	
Financial Data	Consumer with 780 FICO® Score	Consumer with 680 FICO® Score
Bank Card 30-days delinquent	90-110 point drop	60-80 point drop
Mortgage Charge-off or foreclosure	140-160 point drop	95-115 point drop
Filing Bankruptcy	220-240 point drop	130-150 point drop

Source: Fair Isaac Corporation

The payment history factor considers all of your credit accounts, collection accounts, and public record items. When looking at late or missed payments, it asks: How late were they? How recent are they? How many are there? How much was owed? Finally, negative credit impacts your score. It appears obvious that trade lines with owed balances on defaulted or closed accounts makes you look like a loose cannon on the field. It is important to remember that the more recent a public record or delinquency, the more those items will impact your score. As time passes and you build positive credit items, the negative items have a decreasing score impact.

The **amount of debt** is worth 30% of your score, and it shows how financially disciplined you are in playing the credit score game. The amount owed compared to the credit limit reflects whether your financial situation can bear more credit. This is also known as the utilization rate. Here, FICO® considers the amount owed across all accounts, which is the total balance on your last credit report statement. It also looks at the amount owed on specific account types, such as the revolving and installment account balances compared to the overall amount owed. The number of accounts with a balance is factored in because "too many accounts with a balance may mean you are overextended."

The utilization rate "is an important factor," FICO® says. "If you're close to maxing out your accounts, you might have trouble making payments in the future." The amount that remains owed on an installment account is a big factor. For instance, say you still owe $12,000 on a $15,000 loan, you take a score hit. On the other hand, if you have paid off half or more of that loan, you will see a score increase because you are showing an ability and willingness to manage debt.

"In some cases, having a very small balance without missing a payment shows you have managed credit responsibly and may be slightly better than carrying no balance at all. On the other hand, closing unused credit accounts that show zero balances and that are in good standing will not raise your score," says Fair Isaac. Notice it says a small balance may have a slight positive score effect; we must balance this slight effect against the cost of losing our credit card's interest rate grace period. We think this minor effect is not worth the financial loss incurred from paying interest. Nonetheless, FICO® says game managers have an average of three accounts that carry a balance. Most owe less than $3,000 on revolving accounts.

The utilization rate must be carefully played, especially when you are seeking to obtain credit. Think about it; the only time your credit score matters is when someone pulls your CR and credit score. When that occurs, you want them to see a stellar record. Bad payment history remains for seven years and good payment history for 10 years from that activity, so you can't hide it. The utilization rate, however, changes every month as you pay the bills. For example, let's say we have a credit card with a $2,500 credit limit. Each month, we use that card to pay $1,700 in bills, which means that card has a 68% utilization rate before the bill is paid and that payment is reported to the NCRAs.

How this is viewed is that we only have a 32% cushion of available credit remaining. The closer the account is to maxed out, the more likely it is that an account will soon go into default. This makes sense, as when people need money, they utilize credit. As Fair Isaac says, "Owing a great deal of money on many accounts can mean a person is overextended and is more likely to make some payments late or not at all. Part of the science of scoring is determining how much is *too* much for a given credit profile."

The utilization rate looks at your individual accounts and all of them in total. "Well, what does it take to obtain credit optimization?" you ask. Maximum points are achieved by having a utilization rate of 10% or less of the available credit limit. Soon, all this will come together when we explain how to pre-approve yourself for a loan. The point here is to understand score composition fundamentals. The final point on optimization is to avoid going over your credit limit, as it is not only a score hit, it is something creditors look at when determining whether to approve your loan; it shows how disciplined you are in exercising your credit.

There are a few factors that do not comprise percentages of a score, but each of them are still important. It is beneficial to have one name and one address. The issue of having one name was covered on page 51. The addresses can have an impact in two ways. First, if you have multiple addresses, you appear unstable. Second, where you live is huge. There is a thing called demographic profiling. This is based on your zip code. Here, it really hurts to live on the wrong side of town. Some creditors will not give you a loan if you have certain addresses. Because it is illegal, they will use other reasons to deny the credit application. Certain zones are red lined, meaning anyone with an address in that zone gets courteous face time, but their loan application is rejected. No banker will admit it, but it happens in real life.

There is a simple solution to demographic profiling: obtain a mail box with a physical address in an affluent area. There are many businesses that offer such boxes, and they appear like an apartment number. This will provide an affluent area address for all trade lines. It is not unusual for someone to have a different living address and billing address. Businesses do it all the time; your financial life should be viewed as a business. As you move, you maintain address stability. Moreover, using a box address prevents identity theft because your mail is under lock and key, so thieves cannot raid information from the unsecured mailbox at your residence.

As you see, multiple factors have varying degrees of impact upon your credit score. Thus, the key to Winning the Credit Score Game is to be a manager rather than just a player. It is essential to understand what builds credit and what doesn't. Neither checking, savings or stock accounts build credit, nor do debit cards or check cards. Those accounts may, however, be used as leverage or collateral to obtain credit. Only items that appear on your CR build or impact your credit.

Now that we have addressed how your credit score is factored, it is time to learn the precepts and rules of managing the game to win. You must utilize them to optimize your credit usage to its fullest potential and to build that 760+ credit score. The competition utilizes the rules to their advantage. Do you know who the competition is? The competition is anyone who extends credit to you for interest.