Understanding credit utilization

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To build a good credit score, most people know that paying bills on time and not having too much total debt compared to income go a long way to establish creditworthiness.

But there's another important credit score factor which is less known and much less understood. That is credit utilization, also known as a debt-to-credit ratio.

Credit utilization looks at how someone uses credit cards and how disciplined that person is in credit use. Credit cards are considered revolving credit since levels owed can vary each month, unlike mortgages and car loans, where monthly payments are fixed. Individuals can find out their credit utilization by adding up their credit card limits and dividing by how much of the limit is used. A person with a $1,000 total credit card limit and $900 in total credit card debt has a debt-to-credit ratio of 9-10, which is very high.

Smaller is better for a credit utilization number, said several personal finance experts. There's no set figure of how much it should be, but Eleanor Blayney, consumer advocate for the CFP Board of Standards, said optimally a person would use only between 10 percent and 30 percent of the credit limit. Based on the $1,000 example, that's using only $100 to $300 of the limit at any given time.

Why? Credit agencies are looking for people who are disciplined enough to use credit sparingly and are not tempted to run up big balances.

"Anything higher than that (10-30 percent level) and they look at you like (you're) a little riskier, although there's no 'magic' number," said Howard Dvorkin, founder of Consolidated Credit Counseling Services and author of "Credit Hell: How to Dig Out of Debt."

Anthony Sprauve, spokesman for MyFICO, the consumer arm of credit ratings agency FICO, said credit utilization falls under the "amounts owed" category of FICO scores. When breaking down the components of a FICO score, payment history accounts for 35 percent of the score, while the "amounts owed" category comes in second, at 30 percent. Lenders used FICO scores to determine the credit risk of an applicant, and a high FICO score can mean lower interest rates for loans.

What's important about credit utilization with regard to credit scores is that paying off a balance each month doesn't affect your debt-to-credit ratio, Dvorkin and Sprauve said. That's because when a credit check is done, the firm pulling the information essentially gets a snapshot of the amount of credit card debt the person has on the day the credit card company relays the information.

Consumers planning to shop for a big-ticket loan for a car or a house should try to limit credit card use at least 30 days ahead of time, Dvorkin said. That goes even for people who pay their balances off each month. "I know that's easier said than done," he said.

Sprauve said another tactic is to pay off half the bill to lower the amount owed, which lowers the debt-to-credit ratio.

Don't open new cards; cancel them with care

A high total credit card limit gives a person a little more flexibility to keep a small debt-to-credit ratio. But Jonathan Fox, professor and director of the Financial Counseling Clinic at Iowa State University, along with Dvorkin and Blayney, stressed that people should not rush to open new credit cards to boost their limit.

Not only does opening a new credit card mean a credit check and a small, temporary reduction in the person's credit score, but because it's new credit, there's no history on how the person can handle more credit, they said.

Consumers are better off requesting a raise from their current credit card company if they want to lift their limit as that doesn't ring bells at the credit agency the way a new credit request does, Sprauve said. However, that's not a license to spend more, he said, adding that spending discipline is still necessary.

Many people are trying to reduce debt and want to close cards once balances are paid off. Closing cards will reduce the amount of total available credit, which will affect the debt-to-credit ratio. If someone had two credit cards of $500 each, for a total limit of $1,000, and she or he closed one card, the total limit falls to $500. Therefore, to keep the credit utilization in the optimal, 10 to 30 percent range, that would limit the person to putting between $50 to $150 on his or her card.

For people who are trying to pay down existing balances and get a better handle on their debt, Fox said, it's better to close out the newest credit cards and keep the ones with the longest credit history, especially if there are no annual fees.

Fox and Sprauve also suggested if a cardholder wants to keep open the older credit cards to retain the higher limit, he or she should use those cards only rarely to keep them active. "Forget the number, erase it from where you've saved it online, put the card in a drawer. If you stop using it completely the company will cancel it, so use it once in a great while," Fox said.

Not everyone agrees. Blayney said it is OK to cancel the newest cards first, but she isn't keen on keeping open older cards that aren't being used just to keep a higher credit utilization score. There's a big reason for that — closing a card that isn't being used means "there's less chance for identity theft," she said.

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