Seven Steps to Stellar Credit

By Erin Burt, Kiplinger Personal Finance, June 30, 2005

It's a classic Catch-22: You've got to have credit to get credit. So where do you start? With step one in our seven-step guide to building a strong credit record. Plus: Three rules for boosting your credit score.

It's a modern twist on the classic chicken-or-the-egg conundrum: You can't get credit until you have a history of repaying credit.

For millions of young people just starting out in their financial lives, getting approved for a credit card, auto loan, mortgage or other line of credit can pose a challenge. If you don't have a record of making payments or managing credit, lenders don't know whether you're reliable. They'll likely turn you down or charge you higher interest rates until you can prove your creditworthiness.

Better to establish and build a credit report for yourself now before you need to borrow money. This will take some time -- in order to have a credit score, you must have had credit for at least six months with at least one of your accounts updated and reported within the past six months, according to Myvesta, www.myvesta.org an organization that educates consumers about credit. But it's not enough just to establish a credit report. When you get credit, it's important to follow these key steps to net the best possible score:

Make your payments as soon as you get your bill. Avoid waiting until the last minute. If you push it to the due date, any little snag could cause you to be late -- no Internet access, ran out of stamps or got lost in the mail. Making your payments on time is one of the main factors that determine your credit score. A single missed payment can drag down your score, and the incident can stay on your record for up to seven years. Late payments can also cost you extra in fees as well as trigger a higher interest rate. Also try to pay more than the minimum required on your loans and credit cards each month. You'll pay them off sooner and save a bundle on interest.

Don't max out your credit cards. Lenders look at how much available credit you actually use. Keep your credit card use to less than 30% of your credit limits, advises Liz Pulliam Weston, author of Your Credit Score: How to Fix, Improve and Protect the Three-Digit Number That Shapes Your Financial Future. So, if your card carries a $500 limit, try to keep your spending below $150 -- even on a secured credit card. Not only will this strategy help you to get the best possible rates, it can help you avoid getting in over your head in debt, says Weston.

Don't carry a balance. One of the biggest myths about credit is that you need to carry a balance month to month in order to build a history. Not so. In fact, credit scores don't even distinguish between those who carry a balance and those who don't, according to Consumer Credit Counseling Services. Go ahead and use your credit card each month, but stick to smaller purchases you can afford to pay in full. You'll save money on interest charges and you'll be less likely to get into trouble down the road.
When it comes to building your credit, a little discipline can go a long way.

If you're starting from scratch, these seven strategies can help get your credit history off the ground:

1. Open a savings and checking account. Although they aren't considered "credit," these accounts may show up on your credit report. Lenders view savings and checking accounts as signs of stability. Over time, your withdrawals and deposits will show that you can handle money responsibly, and that you have reserved cash to cover payments. But be careful not to bounce any checks, which will scuff up your report.

2. Pay all your bills when you get them. Credit cards, student loans and other debt aren't the only bills that can impact your credit report. Your cell phone, cable TV, utilities and Internet service may show up as well, so it's important to stay on top of all your bills. Years of on-time payments may or may not get reported. But one wrong move and -- bam! -- it's on your credit report. A great way to make sure you don't miss any payments is to pay your bills electronically. Many banks now offer the service for free, and you can use helpful on-site calendars or financial software, such as Microsoft Money or Quicken to schedule some bill payments automatically each month. You could also go with a reminder service, such as Memo to Me http://www.memotome.com/ or www.RememberIt.com, that notify you via e-mail or cell phone when it's time to write a check.

3. Make a secure start. One of the best ways to build a credit history from scratch is with a secured credit card. These cards allow you to make a deposit with a lender (such as your bank or credit union), and the amount usually becomes your credit limit. The issuer takes on zero risk because if you don't pay on time, it can dip into your account to cover the bill. Most issuers require a deposit of $300 to $5,000.

You build a history just as fast with a secured card as with a regular one, says Ryan Sjoblad, a spokesman for Fair Isaac (FICO) www.myfico.com, a credit-scoring company. After making payments on time for a year with a secured card, you should have an adequate history to switch to an unsecured card. You'll want to shop around for the lowest fees and interest rates on secured cards. Avoid those that charge application or processing fees. And make sure the issuer reports to the three major credit bureaus -- some smaller banks may not.

4. Get a credit card in college. This may seem like irresponsible advice for us to give. After all, the average college student graduates with four credit cards and carries a balance of nearly $2,200, according to a recent study by Nellie Mae, a student loan provider. But credit cards are pretty simple to come by in the ivy-covered halls. Lenders practically beg college students to take cards off their hands. If you can establish a reliable credit history while you're still in school, you'll be prepared for when you want to buy a car or a house after graduation.

Try to limit yourself to one card. Learn more about getting your first credit card, and how to shop for the best deal.

5. Get store credit. Consider getting a card to finance purchases at your favorite retailer or gas station. Qualifying for these cards is generally easier. But be careful -- too many of these cards can actually hurt your credit score, says Weston. One or two should suffice.

Shop around for the best deal and read the terms carefully. Watch for annual fees and other charges, and make sure you know how long you have to pay the balance before interest kicks in.

6. Borrow someone else's good credit. If you simply use your parents' credit card, your credit history will remain a blank page, no matter how responsibly you manage your spending. Ask them to add you as an authorized or joint user, however, and your credit report may be updated with your parents' history with that account over the years, says Weston. (Make sure the issuer reports authorized and joint users to the credit bureaus, though. Some only report such users if they are married to the original account holder.) Of course, you'll want to make sure they really do have good credit because any of their mistakes would then become yours too. Getting someone to cosign a loan is another way to qualify. Make your payments on time and you can build a solid history. But, again, if you miss a payment, it's not just your credit that will suffer -- it'll show up on your cosigner's report as well.

7. Don't open too many new accounts at once. When it comes to building your credit, patience is a virtue. It takes time to create a solid record of consistency in making payments to demonstrate your creditworthiness. Start

off slowly with one or two accounts. Use them responsibly for at least six months to one year before applying for another, if you need it.
Applying for too many accounts in a short period of time could be a red flag to lenders, according to Equifax, one of the main credit bureaus, especially if your credit history is less than three years old. Even if you don't qualify or open an account, each application for credit can remain on your report for two years.

Applying for too many of the same kinds of accounts can also drag down your score. Lenders like to see that your money management skills are well-rounded. A checking account, a secured credit card and a co-signed car loan, for example, show more versatility than a pocketful of Visas.

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