Damage Control for Your Credit Score

By Michelle Singletary
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Many credit card users are in a panic as lenders snatch away long-held but unused credit cards or significantly reduce their available credit lines.

For some, the move will result in lower credit scores. And a lower credit score means you pay more for the money you borrow. It can also mean higher insurance rates for your home or car, or worse, the loss of a job.

For others, the reduction in available credit or the cancellation of a card won't be more than a tiny sting you get when you're dumped by someone you didn't care much about anyway.

Which of the scenarios you fall into depends on how much outstanding debt you are carrying.

For example, here's a question I got from a worried reader: "I recently received a notice from First USA that my credit card with them had been canceled, since it has had a zero balance for at least 24 months. I can't even remember the last time I used it. I am concerned that this will hurt my credit score. My credit score has always been pretty good. I use two credit cards (one jointly with my husband) and they are paid off monthly. What can I do to minimize damage to my credit report and credit score from this closure?"

The credit-scoring algorithm looks at the credit utilization rate for each active account and several similar accounts together. If your credit issuer slashes what you can borrow or cancels your card, it can change for the worse the percentage of credit you are using compared with what's available to you.

This questioner falls into the dumped-but-I-wasn't-interested-in-you-anyway group. Because she doesn't carry balances on her cards, she doesn't need to worry about damage control.

"If a person's credit report shows low balances, relative to credit limit, on all revolving accounts, then such an action by a lender would likely have little impact to the person's score, since any change to the already-low overall credit utilization rate would likely be small," said Craig Watts, public relations director for Fair Isaac Corp., which created the FICO credit-scoring system used widely by many lenders.

Additionally, if a lender closes an account, it won't affect how the scoring system looks at the history of the account because it will likely remain on the consumer's credit history for several more years, Watts said. The FICO scoring system considers the age of all accounts on the person's credit report, open and closed, when determining length of credit history. And it doesn't matter who closed an account.

But if you carry over credit card balances, you may need to be concerned.

Let's say you have three active credit cards, each with a credit limit of $10,000, for a total of $30,000 in available credit. Here's how the breakdown of your credit usage might look:

-- On card No. 1, you owe $9,000.

-- On card No. 2, you owe $2,000.

-- On card No. 3, you owe $1,000.

On the first card you have a credit utilization rate of 90 percent. That's too close to maxing out the card. The second card has a utilization rate of 20 percent. You want to keep your rate at 30 percent or less. The third card has a utilization rate of just 10 percent.

"The best and easiest way to get a great FICO score is by living safely away from the edge," Watts said.

Add up the outstanding amount you owe on all the cards and you have a total utilization rate of 40 percent. Even though you have a high balance on the first card, the overall utilization rate isn't too bad.

But what if the lender for the second card reduces your credit limit to $2,000 from the previous $10,000?

You used to have a utilization rate of 20 percent on that card, but now you're maxed out. Lowering that limit also affects your total utilization rate, which is now about 55 percent.

The reduction of the available credit on the second card could have a domino effect, causing your other credit card issuers to increase your interest rates or cut off your access to credit. They may view you as a riskier customer even though you haven't changed your borrowing behavior. For many people, the reduction in credit limits or cancellation of cards is going to hurt them financially.

But there's a blessing in this situation. I was once dumped by a jerk of a boyfriend. It was the best thing that could have happened to me. Sometimes being dumped is just what you need to end an unhealthy relationship you couldn't bring yourself to sever.

It would be great if the long-term impact of this credit crunch is people relying less on credit and more on cash.

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