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Your Credit History: What Not to Do

Last month I discussed the components of a consumer credit score and how it is important to you and your financial future. To quickly recap, the most widespread measure of a person's credit history is the FICO score. This score is used by major reporting agencies Experian, Equifax, and TransUnion and provided to lenders in order to measure a consumer's level of credit risk. These firms collect financial information related to your payment history and use an elaborate calculation to determine your overall score. This score is important because it will at least partially determine the rates you receive on mortgages, auto loans, and credit cards.

As it is difficult to explain exactly what should be done and how long it will take to achieve a perfect score, I'd like to focus on several things that would make your score plummet overnight. That being said, these actions should not be attempted at home regardless of whether you are under adult supervision or not.

Delinquent Payments - Making just a single monthly payment late could decrease your score by as much as 110 points. Forgetting to pay that bill that somehow got moved to the bottom of the priority pile just became a costly mistake since it will continue to be reflected on the report for about the next 7 years. The good news is you can outlive most of your mistakes. The longer it's been since you were late on a payment, the less of an impact it has on your overall score.

High Debt Utilization - Another 30% of your score is based on what is called debt utilization. This ratio measures the relationship between the amount of credit you have available and how much you have used. For example, if you have a few credit cards all with a total limit of \$20,000 and have balances on those cards totaling \$19,000, your utilization ratio is high at 95%. This will have a large negative impact on your score so if you are currently in this position, you want to pay as much as possible to the principal balance as possible each month. This will not only save you a ton on interest expense, but will get your utilization ratio down to an appropriate level.

Opening New Accounts - Opening new accounts will hurt your score, on average, about 15 points each. The industry has found that people who open new accounts are higher risk immediately after opening the account. Also, the company will make an inquiry toward your history which will take a few more points off. Luckily this only lasts for about 6-8 months given you use the account appropriately.

Closing Accounts - Closing open accounts can hurt your score in basically two different ways. Even if you closed an account with a small limit that you hardly ever use, your score could be hurt if that card was one of the oldest ones you had around. Remember ratings agencies like to see a long, positive history so closing an old account could shorten your all-important track record. Closing an account with a high credit limit could also negatively impact your score since it would increase your credit utilization ratio. If you know you cannot handle your accounts in a responsible manner, go ahead and close them. It is better to take the hit to your score by closing the account rather than abusing it if it were left open.

Defaulting on Debt - Finally and most importantly, the action that will hurt your score more than anything is default on a debt. Breaking the contractual agreement to repay is the one thing no lender wants to see on a credit report and this will drastically reduce your ability to obtain credit. The impact to the actual score alone is significant. A foreclosure could decrease it by roughly 200 points while declaring bankruptcy can take it down by 250 points.

Please feel free to contact me with any questions or comments you may have by email at mdaily@p-s-b.com or by phone at 309-385-4375.



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