Understanding how credit scores work is complicated. A credit score can be a powerful financial tool if managed wisely, but can have negative consequences if the consumer is not educated. When you apply for credit, increase a credit line or make a late payment—all these things can affect your credit score in different ways. If the credit score is on the low side to begin with, it can affect the score significantly than a higher credit score.

To better illustrate the point, let’s look at some actual credit scores* and see how “credit events” affect each differently. For obvious reasons of privacy, let’s just call them “Jane and John Doe.” Jane has always been great with her money and how she uses credit. Her score is 793. John, on the other hand, has had some trouble in the past with how he deals with money. His score is only 576.

Here are some credit event scenarios:

- **Getting a New Credit Card** — Jane 793 to 791, -2 points. John 576 to 557, -19 points. Let’s start by looking at what happens to the Does’ credit when they add a new card with a $15,000 limit to what they already have. In Jane’s case, she already has several credit cards and adding a new one barely changes her score, but not so for poor John. If John could even qualify for a new card, it will cost him 19 points against his credit.

- **Increase Credit Limit of Credit Cards by $10,000** — Jane 793 no change. John 576 to 612, +36 points. Jane already has several credit card accounts, so increasing her credit limit by $10,000 doesn’t change her score because her credit card utilization is already 0%. As for John, the extra $10,000 in credit line lowers his credit card utilization significantly and therefore boosts his score by 36 points!

- **Closing Oldest Account** — Jane 793 no change. John 576 to 558, -18 points. Established credit accounts are great for showing credit history and adding numbers to your score. For Jane, who has a long line of established credit, closing an old account has little or no effect. But for John the results are damaging. Closing his oldest account costs him 18 points because he loses any good credit attached to it. And it doesn’t work both ways. If you close an account with a mediocre history... that history stays with your credit score.

- **Paying Off All Credit Card Debt** — Jane 793 no change. John 576 to 615, +39 points. Jane always, always pays off her credit card debt and carries no balance on her cards. This doesn’t change a thing for her. But for John, it’s a big benefit. Paying off all of his credit card debt raises his score by 39 big points and goes a long way to establishing good credit.

- **Increase Credit Card Debt by $10,000** — Jane 793 to 769, -24. John 576 to 556, -20 points. This is where Jane’s good habits actually hurt her score more than John’s. By increasing her credit card debt by $10,000, her score drops more than John’s because she had no debt prior to the $10,000, whereas John has some preexisting debt.

- **Allow 1 Monthly Account To Become 30 Day Past Due** — Jane 793 to 759, -34. John 576 to 558, -18 points. Poor Jane, she’s had a bad month or two and misses her first monthly payment. For John, this is old school. This will hurt Jane more than John because a 30-day delinquency for someone with no prior problems is an early warning of default risk and changes her score by -34 points, almost double the points that John will lose.

- **Have On-Time Credit History for 24 Months** — Jane 793 no change. John 576 to 595, +19 points. This is John’s moment to shine. By paying his bills on time for 24 months he can increase his credit score by 19 points. Paying bills on time for 24 months does not affect Jane’s score because she has paid her bills on time for over 10 years, establishing a great credit rating.

Credit and credit scores have always been confusing and difficult for consumers to understand. Whether you’re like Jane or John Doe, it’s important to become educated and better manage your credit. By doing this, you will be able to see how using credit wisely can go a long way toward building your financial health. This will enable you to build wealth and save you a lot of money in your lifetime. This is key to have access to financial opportunities along the way and borrow money from lenders if you need to.

Source: www.creditkarma.com