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Business

Credit card balances reduce credit scores

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Question: I am planning on purchasing a property in the next three months and I've been hearing a lot of confusing information about credit card balances reducing credit scores. Can you tell me the facts relating to balances on credit cards and credit scores?

Answer: This is an excellent question and has caused great confusion among consumers. Revolving credit, which includes credit cards, overdraft on a checking account, and some home equity lines of credit, affects credit scores more dramatically when balances increase.

When it comes to the Fico score (most commonly used by bankers) as revolving credit balances inch up towards the aggregate limit, scores drop. The closer the balance gets to the limit, the more the score decreases. To have the best credit scores that balance to limit ratios will offer, consumers must carry no more than 7% of limits.

Does this mean one must always have low balances?

No. What it means is if you are applying for a mortgage loan or any type of financing where credit scores may alter the rate and fees paid, reducing balances down to 7% of limits, a few months prior to applying for the loan is a great choice.

Since balance updates are not immediate it is important that consumers give enough time for the change to show on their credit report. If scores increase by 20-100 points due to lowering balances, personal savings may very well amount to hundreds and thousands of dollars over the life of a mortgage loan.

For example:

Susan and Fred are applying for a $400,000 mortgage. The married couple's balance to limit ratio on their revolving credit is 85%. This has reduced their credit scores down to a 680. Having a 740+ Fico score would give them a 4% interest rate.

At the 680 current Fico score they would have to pay an additional $11,000 upfront at closing in points (a point is 1% of the loan) to buy the interest rate down to 4%. If they did not have the $11,000 available to pay at closing, above all the other costs included, they would have to pay 5% in interest on the loan. This means they would be paying $85,545 more over the life of the loan just because their score was 60 points too low.

Remember, "Great credit brings great opportunity!"