How to Build (or Rebuild) Credit

By Janet Berry-Johnson, CPA

Whether you're looking to build credit for the first time or rebuilding credit after a few money missteps, you're probably facing a common conundrum: you need credit to have a credit score, but you need a good credit score to get approved for loans and credit cards.

In this guide, we'll explore how to overcome this "Catch-22" of credit, why it's important to build good credit and how you can use it responsibly.

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What do we mean by building credit?

Simply put, building credit means building credit history. It means having credit accounts, such as credit cards and various types of loans, using them responsibly over time and paying them off as agreed. Essentially, credit is a form of trust with financial institutions. As you build credit, you build trust with potential lenders over time, making it more likely they would be willing to lend you money in the future.

Why is it important to build good credit?

Good credit plays a vital role in your financial life. Most people think of good credit for obvious reasons like getting a credit card, car loan or mortgage. But credit can play a role in less obvious things like renting a car, apartment or home; getting approved for a cell phone contract, and perhaps even getting a job.

When you apply for a loan or lease, the lender typically wants to see a credit reference to see if you'll be able to manage responsibly the money they lend you by paying them back on time. Some employers check credit references as well, particularly when the job you're applying for involves handling money or dealing with confidential financial information.

The most common type of credit reference is a credit report from one of the three major credit bureaus – TransUnion, Equifax and Experian. Your credit report includes information about your past and existing credit accounts. It outlines how much you owe, how long you've been using credit, and whether you consistently make on-time payments.

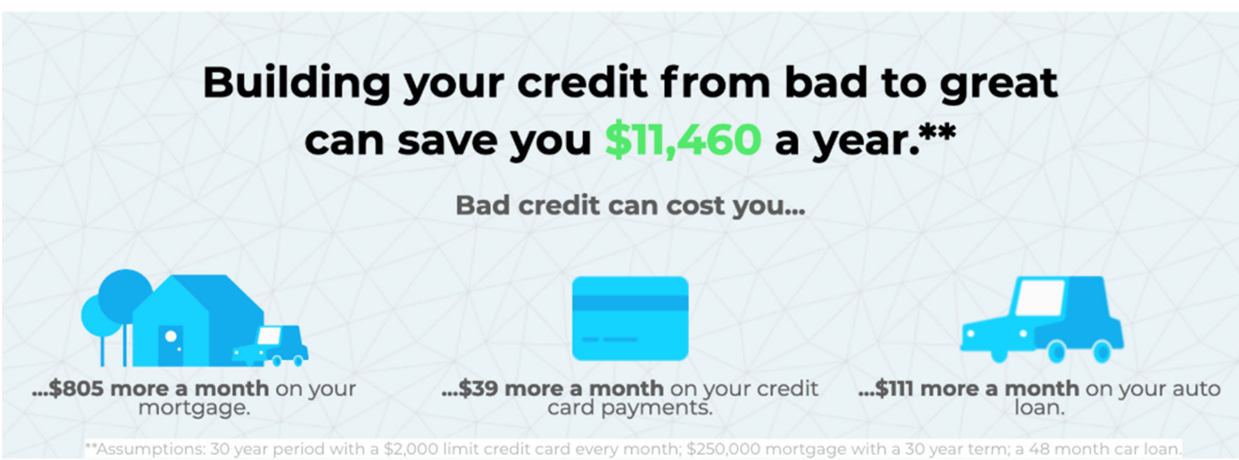
Your credit score, on the other hand, is like a grade that's given to your credit report.

Good credit could save you, big time

A good credit score not only makes it easier to get credit, it can also save you thousands of dollars over your life. Let's walk through an example in which you're planning to take out a $250,000, 30-year fixed rate mortgage.

According to myFICO's Loan Savings Calculator, with a FICO score of 760 to 850 (an Excellent score), the Annual Percentage Rate (APR) on your mortgage could be around 4.291%. If your score dropped to somewhere between 680-699 (a Fair credit score), your APR could be 4.695%.

That doesn't seem like a huge difference, but over the term of a 30-year loan, **the lower credit score would cost you $21,595** in additional interest payments.



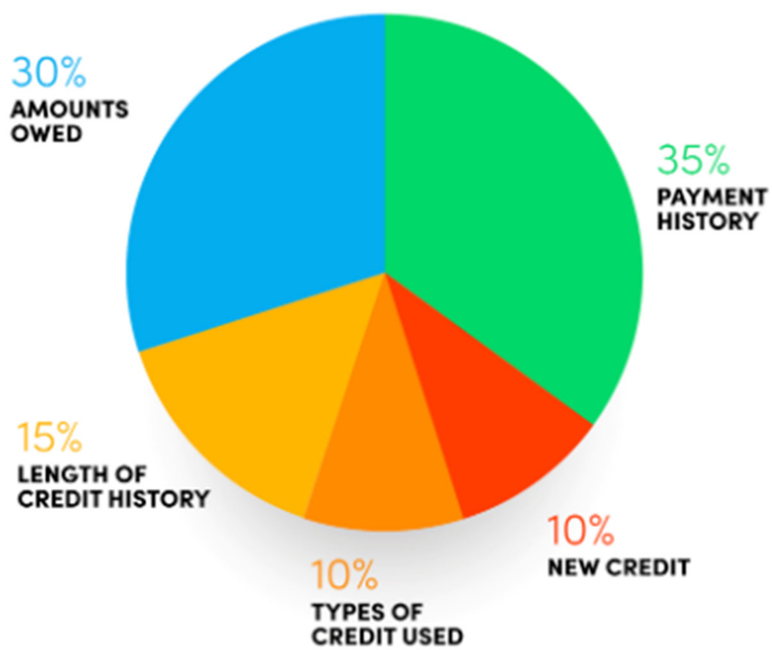
The good news is that building solid credit is not mystery, as long as you understand the fundamentals.

How credit scores work

How do you get a strong credit score? It begins with understanding how credit scores are calculated and what matters most on your credit report.

There are five factors that impact your credit score, in order of importance:

1. Payment history
2. Amounts owed
3. Length of credit history
4. Types of credit
5. New credit



*Percentages based on FICO scoring model (Source)

Factor 1: Payment History

The most significant factor in your credit score calculation is payment history, making up 35% of your score. A history of late payments will drag your score down, as will negative marks from bankruptcies, foreclosures, and accounts being referred to collections.

Factor 2: Amounts Owed

The amount of credit you're using in relation to your total available credit accounts for 30% of your credit score. This is called your credit utilization. Credit scoring agencies view using a large percentage of your available credit as risky behavior. The industry standard is to keep your credit utilization to under 30% of your total available credit.

Factor 3: Length of Credit History

The length of time you've been using credit counts for 15% of your credit score. It considers the age of your oldest account, the age of your newest account, and an average age of all accounts. In general, the longer you've been using credit responsibly, the higher your score will be.

Factor 4: Credit Mix

This is the mix of credit cards, installment loans, mortgages, and other types of credit you're using at any given time. The types of credit you use counts for 10% of your credit score.

On a basic level, there are two types of credit – revolving and installment credit.

Revolving credit accounts allow you to borrow over and over, up to an approved amount set by the lender. One example of revolving credit is a credit card.

Though they perhaps get the most hype, credit cards aren't the only type of credit out there. The second major type of credit that impacts your credit report is installment credit.

Installment credit usually takes the form of a loan. These loans generally come with set terms that state how much you'll pay each month and how long you'll make payments. In other words, you make regular installments (payments) towards the loan balance.

The most common installment loans are student loans, mortgages, and auto loans.

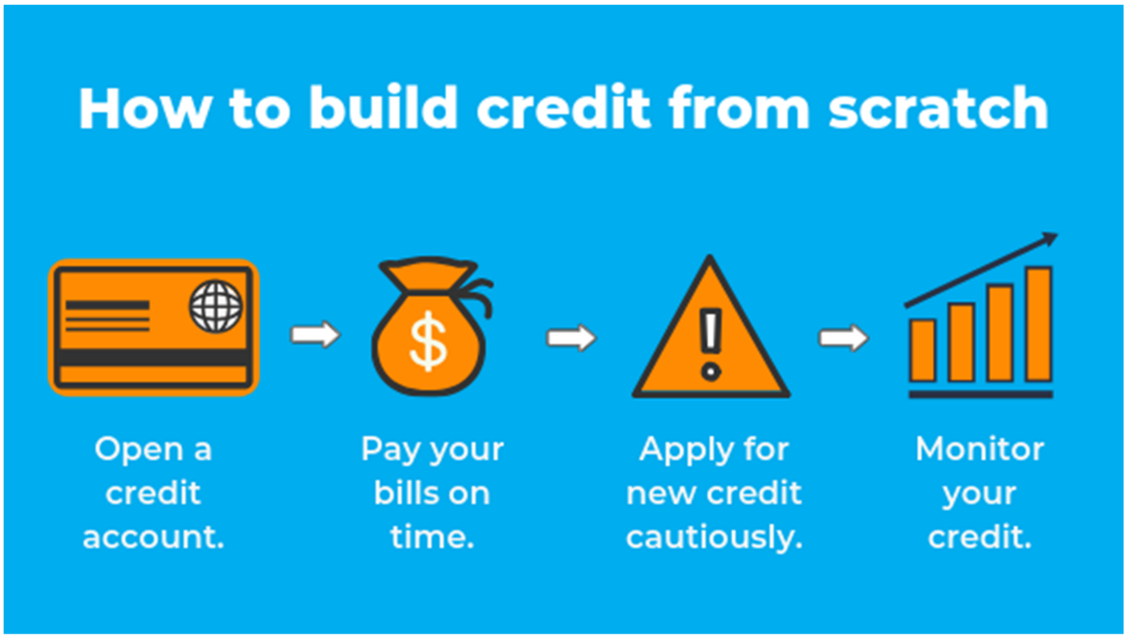
As you build credit, don't overlook the benefits that come from having a diverse mix of credit types.

Factor 5: New Credit

The number of new accounts on your credit report counts for 10% of your credit score. Lenders view opening several new credit accounts in a short period of time as risky, especially if you do not have a long credit history.

Opening too many accounts in too short a time period could indicate to lenders that you could be overextended financially.

How to build credit from scratch



With those five credit score factors in mind, the best way to build credit from scratch is to:

1. **Open a credit account.** You may have to start with a secured credit card or a credit builder loan.
2. **Pay your bills on time.** This includes everything from credit cards and loans to rent payments, utilities, and cell phone plans. Even accounts that aren't normally reported to a credit bureau can negatively impact your credit score if they're referred to a collection agency.
3. **Apply for new credit cautiously.** When you apply for new credit, the lender will check your credit, resulting in a "hard inquiry" on your credit report. Hard inquiries bring down

your credit score, especially if you open several new lines of credit within a short time frame. If you are shopping for a loan, such as a car loan or mortgage, credit rating agencies expect you to shop around for the best rates. For that reason, they ignore multiple inquiries for the same type of loan made within a 30 day period.

4. **Monitor your credit.** Get in the habit of checking your credit report regularly. Analyze it for inaccurate information and dispute any incorrect information with the credit reporting agency immediately.

Ultimately though, building credit is more of a marathon than a sprint – it just takes time. In fact, credit scoring company FICO requires someone to have at least six months of credit history before they will even calculate their credit score.

How do I build credit responsibly?

While we've covered the general rules for how to build credit, let's get into some more specific tools you use to build it. The first step in building credit is to apply for your first credit account. The very first time you apply for credit, the lender will order a credit report. That first inquiry establishes your credit report.

For many people, this first credit application is for a credit card. But without any credit history, you may not qualify for one of the major credit card issuers such as Visa or MasterCard.

The good news is, there are other ways to start building a responsible credit history without a credit card. (And remember, being able to use different types of credit matters too).

Here are a few alternatives to traditional, unsecured credit cards:

- Store card
- Secured card
- Credit builder loans
- Certificate of Deposit-insured loan
- Student card
- Student loan
- Co-signer
- Authorized user

Now let's take a closer look into each.

Store card

Retail store cards have a reputation for approving applicants with no credit. You're more likely to get accepted for a card that can only be used at one store, or a group of stores, than a card that can be used anywhere. To get started with a retail store card, ask your favorite retailer about their options, or check out this post on the five best store credit cards to build credit.

Secured credit card

Secured credit cards require a security deposit and often give you a line of credit equal to your deposit. Once you start using the card, the issuer will send you monthly statements. If you don't pay your bill, the issuer can take the money you owe from your deposit.

Once you've demonstrated that you can handle your card responsibly, the issuer may allow you to have a higher credit line than your deposit or upgrade to an unsecured card and refund the deposit.

Credit builder loans

Although they're not widely advertised, credit builder loans are another option for building credit. Similar to a secured credit card, many lenders that offer credit builder loans collect a deposit and give you a credit limit equal to the deposit amount. Your deposit goes into a savings account that you cannot access until you've fully repaid the loan. As long as you pay as agreed, the lender will send a favorable report to the credit bureau.

You can find these types of loans at a local credit union, or through Self, which is the first company to make these types of loans available online or via mobile app in all 50 states. Another positive about choosing Self? You don't have to make a security deposit to be approved for the loan.

A Certificate of Deposit-insured loan

A Certificate of Deposit (CD) is a financial product similar to a savings account, but you agree to keep your money with the bank for a fixed period of time. In return for letting the bank hold onto your money, you receive higher interest rates than you would from a savings account.

To use that CD to build credit, many banks will let you use the funds in your CD as collateral for a loan. The loan would then show up on your credit report as a secured loan, and would help you build credit when you make on-time payments. Credit unions sometimes call these share-secured loans.

Student loans

Getting approved for federal student loans does not depend on credit, but managing your student loans well will impact your credit score. Remember, whether you make your payments on time, make your payments late, or miss your payments completely, your payment history on student loans gets reported to the credit bureaus.

Co-signer

If you can't get approved for credit on your own, you may have a parent or other close relative who is willing to co-sign on a student loan, car loan or credit card in your name. Having a co-signer with excellent credit may help you get a lower interest rate than you would on your own.

As you make on-time payments, you build your credit. However, if you default (don't pay) on your account, the lender will go after your co-signer to collect the debt.

Authorized user

To get a credit card completely on your own, you must be at least 21 years old. While you can get a card as young as 18, at that age you must either have a co-signer or proof of steady income to qualify.

However, if you’re under age 18 and want to start building credit, your parents may be able to add you as an authorized user on their credit card. This is also known as credit piggybacking. Users over the age of 18 can also take advantage of being an authorized user.

Banks have their own minimum age requirements for adding a minor as an authorized user, so parents should call the number on the back of their card to ask about age requirements. For more, see our guide on establishing credit when you're 18.

Remember, be sure to pick a relative that has a strong credit score, a history of on-time payments and low credit utilization. Becoming an authorized user on an account with a history of missed payments could actually harm your score rather than improve it.

Can accounts that aren’t on your credit report affect your credit score?

You might be wondering about two types of cards that aren’t included on the above list: debit cards and prepaid cards. While these cards might look and swipe like credit cards, they won’t help you build your credit.

Do debit cards or prepaid cards help credit?

When you use a debit card, the funds are taken directly from your bank account, so the transaction is treated as a cash purchase, even if you choose “credit” instead of “debit” at the time of sale.

When you use a prepaid card, you are spending money that you loaded onto the card in advance.

Both debit cards and prepaid cards may have a card network logo like Visa, MasterCard, American Express or Discover on them, but you’re not borrowing money.

Credit cards allow you to buy now but pay later, report your credit history to the credit bureaus and impact your credit score.

Debit cards and prepaid cards, on the other hand, are not reported to the credit bureaus and won’t have any effect on your credit score.

Do rent or utilities affect credit?

Other bills you pay may not affect your credit score, either. Monthly payments for rent, lawn services, and utilities, for example, typically don’t appear on your credit report because the company doesn’t report information to the credit bureaus. If you don’t pay your bill and your account is turned over to a collection agency, however, that collection will impact your credit score.

How long does it take to build credit?

There's no one answer for how long it will take you to build your credit. It depends on a number of individual factors, including the types of credit you're using, the balances owed and the credit scoring model in use.

According to Experian, it can take at least three to six months of activity before a credit score can be calculated. But once you have a score, it can fluctuate often. According to TransUnion, your creditors will likely report to the credit bureaus every 30 to 45 days. So every month your credit score can go up or down depending on how well you manage your credit.

How can I build credit fast?

If you're trying to buy a home or get a car loan, waiting three to six months for a credit score may seem like a lifetime. You might be looking for a way to speed up the process.

Your ability to build credit fast will depend on your starting point. If you have no credit, building an excellent credit score quickly may be difficult because you may have to apply for a secured card and demonstrate your ability to make on-time payments for a few months before you can apply for an unsecured card.

If you've been using credit for a while, how fast you can improve your score will depend on whether your credit report contains negative information and the age of those adverse events. In other words, a late payment within the last three months will have a greater impact than a late payment two years ago.

Assuming you already have a credit file and don't have any recent negative marks on your credit report, here are a few ideas for improving your score quickly:

1. **Review your credit report.** Dispute any errors that might be dragging your score down, like late payments or credit limits that appear lower than they actually are.
2. Pay your bills on time. Your payment history accounts for 35% of your credit score, so make your payments on time every month.
3. **Pay down your balance.** If you have revolving credit accounts with high balances, or carry a balance month-to-month, pay them down as soon as possible. 30% of your credit score is based on the amount you owe, so paying down large credit card balances can have a big impact in a short period of time.
4. **Get a credit card or two.** If you don't have any open credit cards, apply for one or two. Get a secured card or become an authorized user on a relative's account if you can't get approved for one on your own.
5. **Use your cards sparingly.** Remember, most credit experts recommend keeping your utilization rate below 30% - both on a per-card basis and in total. So use your cards, but don't

use them too much. For example, let’s say you have two credit cards with a credit limit of $1,000 each. You might charge up to $250 on each card and pay the balance in full each month. This will keep your utilization rate under 30%.

6. **Raise your credit limit.** If you already have a credit card, try calling the company and asking them to raise your credit limit. This will automatically decrease your credit utilization rate and improve your score.

How long does it take to rebuild your credit?

Rebuilding a damaged credit score can be tougher than starting with a blank slate, but it is possible.

The first step is to check your credit report to see exactly where you need to improve. If you’re trying to rebuild after bankruptcy, you may need to apply for a secured credit card to start rebuilding.

If your issue is a lot of missed or late payments, work on bringing your accounts up to date and set up reminders to make sure you pay your bills on time going forward. If your credit utilization ratio is too high, create a plan to pay down your debt and get your credit utilization rate down to 30% or less.

A bankruptcy will remain on your credit report for seven to 10 years, but you can see an improvement in your credit score much sooner. Just put in the work to rebuild your score and keep in mind the five factors that go into a credit score calculation listed above.

Whether you're new to credit or trying to undo the damage caused by past credit mistakes, building credit takes time. Don't charge more than you can afford to repay, keep balances low and set up reminders to pay your bills on time. These actions will demonstrate that you know how to use credit responsibly and you'll be rewarded with a strong credit score.

About the Author

Janet Berry-Johnson is a Certified Public Accountant and personal finance writer. Her work has appeared in numerous publications, including CreditKarma and Forbes.

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