Cancel a Card, Hurt Your Credit Score

By Dana Dratch

Everyone knows that your credit score is important to your financial life, affecting the rates you get for mortgages, credit cards and insurance. Improving your score may save you thousands of dollars in interest. So would it help your score if you got rid of a credit card?

"Pay your bills on time and keep your credit expenditures under control, and you won't have to worry about your credit rating," says Craig Watts, spokesman for Fair Isaac Corp., which calculates the FICO score for consumers. "If you're having trouble doing that, sometimes canceling a credit card in an effort to get your credit behavior under control is more important than your credit score."

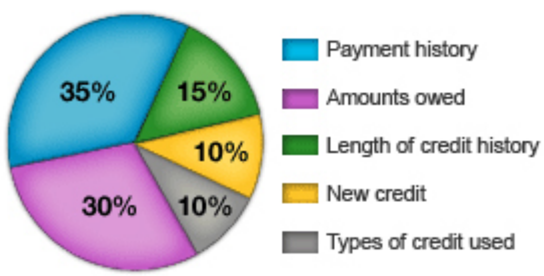
That's the short answer. But since virtually everything that makes up your credit score depends on something else -- depends on your credit mix, the number of cards you carry, the length of your credit history, your rate of credit utilization and myriad other things -- there is a longer answer.

In most cases, canceling a credit card won't help your credit score. In fact, it may actually hurt your score. You see, your credit score depends on how you shake out in five different credit-scoring categories, each weighted differently when calculating that score.

What counts in a credit score?

This chart shows how Fair Isaac Corp. values the various parts of your credit management to determine your credit score. Source: Fair Isaac Corp.

According to Evan Hendricks, author of the book "Credit Scores and Credit Reports," canceling a credit card potentially can hurt you in at least two of the five categories -- and maybe even a third.



Credit-utilization ratio is key First, canceling a card could upset your credit-utilization ratio, the second most heavily weighted category in Fair Isaac's credit scoring algorithms. For example, assume you have three cards with total available credit of $20,000. Assume further that your outstanding balances total no more than $6,000 of that available credit at any one time. Since creditors like to see a credit-utilization ratio of 30 percent to 35 percent or less, you're in good shape. Now, assume that you cancel a card with a zero balance and a $10,000 credit limit. Suddenly, your utilization ratio jumps to 60 percent, and your credit score drops.

As counterintuitive as that seems, that could happen. Impersonal credit-scoring systems aren't concerned so much with how much available credit you have but with how you manage that credit. And in the credit-scoring world, a 30 percent utilization rate is much better than a 60 percent one. "That's what scoring models want to see, a good utilization rate," Hendricks says.

Furthermore, he says, canceling that card could result in a double whammy to your credit score, "because each card is scored individually, and then all your cards are scored together. (If) you've just canceled the card with a zero balance, (you've) lost a great individual score." Regardless, if you still want to cancel a card, he says, "make sure to pay down your other balances to keep that rate in line."

Older credit is better If you do cancel a card, you can compound your error even further by canceling the card that you've had the longest period of time and on which you've been making regular payments. By canceling an old card, the length of your credit history on open accounts will grow shorter. Both the FICO score and the VantageScore credit-scoring formulas take into account the credit histories of even closed accounts in assessing how long you've been managing credit. However, according to Watts, "that history will finally disappear from the formula when a credit bureau of its own accord removes old credit account information from your credit file."

Barrett Burns, CEO and president of VantageScore Solutions (the company formed by the credit bureaus Equifax, Experian and TransUnion), agrees, but cautions that the scoring algorithm "is weighted such that if you maintain that older account, you're better off because it goes to a pattern of payment history." Nevertheless, he says, if it's an older account that you don't use, and you're paying fees on it, "you're probably better off closing it out for privacy rather than credit score reasons.”

There's at least one more nuance to consider, Hendricks explains. If you're intent on canceling a card, cancel a younger card or cancel one on which the credit card issuer doesn't report the credit card limit. "Some credit card companies don't report your credit limit," he says. "You can find out which ones by getting a copy of your credit report."

Number of cards matters Your credit report may also alert you to another reason to cancel a credit card: You can have too many credit cards. Though there is no magic number -- again, because each person's credit situation is so different -- your credit report does give so-called reason codes for your credit score.

There are more than 40 reason codes -- reasons to grant or deny credit -- and up to four are given with your credit report to show what factors affected your score. The most common reason codes, according to Equifax, are as follows.

Most common reasons consumers are denied credit:
• Serious delinquency.
• Serious delinquency and public record or collection filed.
• Time since delinquency is too recent or unknown.
• Level of delinquency on accounts is too high.
• Amount owed on accounts is too high.
• Ratio of balances to credit limits on revolving accounts is too high.
• Length of time accounts have been established is too short.
• Too many accounts with balances.

One of the reason codes (reason No. 4) tells you if having too many cards has hurt your score. Common sense should tell you that the older you are and the better you manage your credit, the more cards you can have in your wallet before you reach the magic number that triggers the reason code (though you may be surprised to learn that 10 or more cards is not too high in some cases). "In any event, if you're in that rare category and have plenty of credit and low balances on the other cards, canceling a card may help you," Hendricks says.

Though canceling a card probably will not increase your credit score, holding on to one has a number of advantages. For one, Fair Isaac and VantageScore look for a healthy credit mix, a mix that might include a mortgage loan, a car loan, maybe a store card or two, three or four MasterCard or Visa cards and a home equity line of credit, or HELOC, for example.

HELOC effect

Of course, it's not simply a matter of having diverse sources of credit. They also want to see responsible credit usage on your part, including credit card balances in the healthy 30-percent-to-35-percent range. "That's a sign of an active and responsible credit person," Burns says. "On the other hand, if somebody consolidates their credit cards or revolving credit down to just a handful of credit sources and has high utilization rate, that will be detrimental to their score."

And this is where credit-score math gets fuzzy. Many consumers have consolidated outstanding credit card balances into a HELOC, both for the lower rate and because they thought doing so might help their credit scores. (For what it's worth, Fair Isaac's Watts wonders whether mortgage brokers, in an effort to generate more loans, first pitched the myth that canceling a credit card would help your score.) Once again, the answer is "it depends."
"Home equity lines of credit are really interesting creatures when it comes to credit scores," Watts says.

What's interesting is that it may make sense to consolidate credit card balances into a HELOC because Fair Isaac may treat the new HELOC as an installment loan rather than a revolving loan. However, Watts points out, that with Fair Isaac that only happens if the HELOC is a large line of credit. Small HELOCs are regarded as revolving lines of credit, much like your credit cards. Thus, as with credit cards, it might help your credit score in some cases to close out a HELOC.

"But in all cases, paying down a real estate-based loan like a mortgage or a HELOC is going to help your score," says Watts.

And that seems to be the key to the kingdom when it comes to credit cards and credit scores: Don't cancel your cards. Pay them off. And after you've done that, don't send them back. Cut them up.

Do that, and you have a zero balance enhancing your credit utilization rate. Do that, and you maintain your credit history on open accounts. Do that, and your credit mix looks good. Do that, and you still have the available credit on the card you cut up. All you have to do is ask for a new card when you need it.

Nevertheless, if you have a compulsion to cancel credit cards, do it the right way. First, cancel your department store cards; then cancel the newest MasterCard or Visa with the lowest credit limit, making sure to close the card from the company that doesn't report credit limits.

"And make sure to keep your credit-utilization ratio in line as you cancel, paying down balances on your other cards, if necessary, to keep it in line," says Hendricks. Score one for the consumer.

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