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11901 Samuel, Garden Grove, CA 92840-2546

If I pay off loan, how's my credit score?

By Steve Bucci • Bankrate.com

Dear Debt Adviser,
To avoid debt, most people like to pay off their bills when they have some extra money. When you have an installment loan, is it best to pay it in full early or only pay the payments as agreed? I am trying to get my credit score up and have been paying old debts. I was looking to pay off a loan I've had for only four months just because I have the money to pay it off, but I didn't want to hurt my credit.
-- *Shawna*

Dear Shawna,
I can tell from your question that you pay attention to details! But I want to caution you to not miss the bigger picture of your financial puzzle because you are concentrating on the individual pieces.

Don't get me wrong -- it is great that you are concerned about how your credit is reflected in your credit score and credit reports. I also want you to remember that strong finances drive a good credit score, not the other way around! So any decisions you make about paying off your loan should be based on what is best for your overall current and future financial situation, not solely on how it will affect your credit score.

For example, the money you are using to pay off the loan may be better utilized in an emergency savings account if you don't already have the recommended emergency fund with money to cover six to 12 months' worth of living expenses. If you have to choose between having an emergency fund and having no debt, I suggest you go for the first option. Why? Because without sufficient emergency savings, you won't have any shock absorbers to cushion you when unexpected expenses pop up -- and they will!

In addition, you mention that you are paying off old debts in addition to new ones. Before you pay off your new installment loan, be sure that all accounts with any outstanding payments have been brought current and that any collection or charged-off accounts have been paid. Next on your pay-down list are credit card accounts on which you are carrying balances. Paying off or down your credit card balances will not only improve your financial health but also boost your credit score.

There are two major credit-scoring models in use today: FICO and VantageScore. Credit scoring elves at these companies like to see credit card accounts with zero or low balances. Using the cards and paying off the balances each month is a good way to max out your credit-scoring potential for revolving accounts.

Here's an answer for your question regarding how paying off your installment loan would affect your score: For both your FICO and VantageScore credit scores, it would be better to keep paying the loan on time and as agreed each month. Paying the loan off would not necessarily lower your credit score, but keeping the loan open and at a low level shows that you can manage the payment each month, and that will help boost your score.

While both scoring models reward a consumer for making ongoing, on-time payments on an installment loan, the VantageScore model pays more attention to the first 12 to 24 months of the loan life cycle and gives more weight to those payments than to activity on the account after approximately two years. So, if your financial house is otherwise in order, you might consider paying down the installment loan over 24 months and then getting rid of it. Then, you can redirect that monthly expense to help fund one of your short- or long-term financial goals.