What is the Credit Utilization Ratio?

Description

Do you know someone with a habit of maxing out their credit cards? Someone who seems to perpetually carry an immense balance on their cards? Maybe it’s due to lavish shopping sprees or a drive to maximize travel points. Or maybe they simply have fewer payment options and must continually rely on [credit cards](#).

Whatever the reason for this excessive credit card usage, the fact is that it has genuine implications for your finances — especially your credit score.

Credit utilization is a vital factor that determines a considerable portion of your credit score. With a [high credit score](#), you have more choices when shopping for credit products, which can help you achieve your financial goals. As a result, understanding how credit utilization works is crucial.

What is credit utilization and how is it measured?

Credit utilization refers to the amount of outstanding debt you owe relative to your available credit limit. It’s also known as the credit utilization ratio and is typically expressed as a percentage.

For example, suppose the credit limit on your credit card is $5,000. You then make several purchases that amount to $2,000 and charge them to your card. Your credit utilization ratio in this case would be 40% ($2,000 / $5,000). If you proceed to pay off $500 of the balance, your credit utilization ratio will drop to 30%. Should you do the opposite and tack on further charges, it would rise.

Credit bureaus measure your credit utilization based on the balance on each credit card you own and the combined balance of all your cards. Both measures are relevant to your credit score.

Why does credit utilization matter?

Your credit utilization ratio has a significant bearing on your credit score. It accounts for 30% of your overall credit score, so keeping it in the optimal range is critical.

A high credit utilization ratio negatively affects your credit score, which will make it harder for you to qualify for a variety of credit products. The rationale behind this downgrade is that lenders will perceive you as a high-risk borrower. Naturally, the more your credit limit you utilize, the greater the likelihood you'll miss payments or default altogether.

In general, lenders like to see a credit utilization ratio of 30% or lower before extending credit to an applicant. This rule-of-thumb applies to each credit card and all your cards in aggregate.

How to lower your credit utilization ratio

A low credit utilization ratio can enhance your credit score, allowing you to gain access to a broader array of credit products and favourable interest rates. As mentioned, lenders feel more at ease offering credit to borrowers whose credit utilization ratios fall below 30%. Therefore, you should aim for this target.

Below are some techniques you can employ to keep your ratio from exceeding this sweet spot:

Cut spending and pay down your debt

By cutting back on credit card usage, you could see your credit utilization drop quickly. Also, make a concerted effort to pay more than the minimum payment every month, and make payments more frequently if you can.

Raise your credit limit

Raising your credit limit is one of the most efficient and convenient ways to bring down your credit utilization. Just ensure you don't simultaneously escalate your credit spending, which defeats the purpose!

Most credit limits rise automatically over time, but you may not have that long. In that case, a conversation with your card issuer may get the job done. Just remember to be courteous and reasonable when negotiating.

Get another credit card

By opening up a new credit card account, you expand the amount of credit available at your disposal. The action translates to an instant drop in your credit utilization ratio.

When you apply for a new card, you may have to undergo a hard credit inquiry, resulting in a minor blemish on your credit report. However, a lower credit utilization ratio confers more benefits in the long run than an occasional hard inquiry.

Use a balance transfer card to consolidate your debt

Under the right circumstances, a balance transfer credit card can be an effective way to lower your credit utilization ratio. It involves moving all or some of your existing debt to the balance transfer card. Then, you make regular payments until the balance is paid in full. Using this method allows you to increase your credit limit and benefit from the low introductory interest rate routinely offered on a balance transfer card.

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