Credit Reports and Credit Scores: What They Are and Why They Matter

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OPENING ACTIVITY: MYTH OR TRUTH?

There are many popular misconceptions about credit scores. What do you know about credit scores? (The agent reads each myth, then let the audience members guess before reading the answer)

One: There is only one credit score.

Myth: There are many different credit scoring models used by different credit reporting agencies and different lenders.

Two: Shopping for a loan lowers a credit score.

Myth: Multiple enquires made within a short period of time do not lower a score. Credit scoring models take into account that consumers may shop for loans that have the best interest rates. Comparison shopping for a loan is recommended.

Three: Credit reports are free.

True: Consumers are entitled to a free credit report every year from each of the three credit reporting agencies. However, there is usually a fee for credit scores. Visit www.annualcreditreport.com for your free credit report or to purchase your score.

Four: A low credit score has little impact on the interest rate a borrower pays.

Myth: Although there are several factors that determine the terms of a loan, a low credit score almost always means higher interest rates. Higher interest rates add thousands of dollars to the life of a loan.

Five: Only banks and lenders use credit scores.

Myth: Some types of credit scores are used by insurance agencies, landlords, and employers.

Lenders, landlords, insurance companies, and potential employers may be checking your credit report or score. Credit scores give a glimpse of consumer stability. Lenders assume that consumers with higher credit scores will be more likely to pay back loans. A person who has a long history of responsible credit management is estimated to be reliable in other avenues as well. A consumer with a solid credit report may be more likely to land the job, acquire the apartment, receive lower insurance premiums, or be offered the best interest rates on a loan. It pays to have a good credit score.

Here are some ways you can build your credit score.

Step 1. Monitor your credit report.

Check your free annual credit report at www.annualcreditreport.com. Beware of copycat sites. You are entitled to a free annual report from each of the three credit reporting companies: Equifax, Experian, and TransUnion. Check your credit report from a different company every few months to monitor your credit report throughout the year. The report contains information from current and past creditors including lenders, amount of installment loan, limits for revolving credit, frequency and amount of payments, and late or missing payments. The report will also show your name, address, and employer – current and previous. Check for accuracy. If you find an error, notify the credit reporting company and the lender. If you suspect fraud, contact the Federal Trade Commission.

Step 2. Check your credit score.

Your annual credit report is free but you must purchase your credit score. Credit scores are available from a variety of different sources. Lenders rely on scores from the three main credit reporting agencies or they may have their own. The scores tend to be close. You typically won't find vast differences from one agency to the next because they are all based on your credit management behavior. Most scoring systems range from 300 to 850. Higher scores qualify for lower interest rates. Most consumers have scores in the 600's or 700's. Check your score at www.annualcreditreport.com. Other sites may offer a free credit score but be aware that it may differ from the scores provided by the major credit reporting bureaus. Watch out for hidden costs such as credit monitoring offers. You need only purchase your one-time score but many websites will try to have you opt-in to a monthly fee to monitor your credit, email a monthly report, or some other service.

Step 3 Understand the scoring system.

Want to improve your score? You'll need to know what factors influence the score. There are several good practices that are critical for any credit score such as making regular, on-time payments; maintaining a low debt-to-income ratio; and having a long history of responsible use of credit. There are some variations among types of credit scores. The most commonly used types of credit scores are FICO® and VantageScore.

FICO® Score

FICO® Scores range from 300-850. There are no hard rules about a specific number that ranks you as a good credit risk but, generally, credit scores in the mid-700's and above are considered excellent. Credit scores in the mid-600's and below are often considered higher risk and these consumers may not qualify for conventional loans.

FICO® Scores are determined by credit payment history, amounts owed, length of credit history, mix of credit, and new credit.

35% Credit Payment History

A long history of making regular, on-time payments is the main component of a good credit score. A few missed or late payments may not be a deal-breaker for a good score. An overall good credit history can outweigh one or two instances of late credit card payments. However, having no late payments in your credit report doesn't mean your score will be a perfect 850 either. There are other factors that determine a credit score.

Account types considered for credit history could include:

- Credit cards (Visa, MasterCard, American Express, Discover, etc.)
- Retail accounts (credit from stores where you shop, like department store credit cards)
- Installment loans (loans where you make regular payments, like car loans)
- Finance company accounts
- Mortgage loans

30% Amounts Owed

Too much credit may mean the consumer is overextended and at risk of being to repay debts. Scores are influenced by the total amount owed and the amounts owed by types of accounts (credit cards or installment loans).

The credit utilization ratio on revolving accounts is the percentage of available credit being used. Maxing out your cards can lower your credit score. Credit card lenders often report our monthly statement amount to the credit bureau; so, even if you pay off the balance every month, it may not be reflected on your credit report.

Paying down installment loans is a good sign that you're able and willing to manage and repay debt. For example, if you borrowed $10,000 to buy a car and you have paid back $2,000, you still owe (with interest) more than 80% of the original loan.

15% Length of Credit History

You have to use credit to have a credit history. The longer your positive credit history, the better. You can bounce back from a bad credit history and show a recent good credit history. Late payment behavior in the past can be overcome; re-establishing credit and making payments on time will raise a credit score over time.

10% Credit Mix

Credit cards, retail accounts, installment loans, finance company accounts and mortgage loans are different types of credit. Having credit cards and installment loans with a good credit history will raise your score. Strive for a healthy balance of types of credit. Too many credit cards or having only installment loans can both lower a score. A closed account will still show up on your credit report and continue to affect your score.

10% New Credit

Avoid opening several new accounts over a short period of time. New accounts lower the average account age, lowering your score.

An inquiry is when a lender makes a request for your credit report or score. Inquiries remain on your credit report for two years, although FICO® Scores only consider inquiries from the last 12 months. FICO Scores have been carefully designed to count only those inquiries that truly impact credit risk, as not all inquiries are related to credit risk.

If you apply for several new credit cards within a short period of time, multiple requests for your credit report information (inquiries) will appear on your report. Shopping for new credit can equate with higher risk, but most credit scores are not affected by multiple inquiries from auto or mortgage lenders within a short period of time. Typically, these are treated as a single inquiry and will have little impact on the credit score.

It’s OK to request and check your own credit report. Checking your credit report won’t affect your FICO® Scores, as long as you order your credit report directly from the credit reporting agency or through an organization authorized to provide credit reports to consumers, such as myFICO.

VantageScore

The earlier versions of VantageScore (Model 1 and Model 2) ranged from 501 to 990. The newest versions of VantageScore (Model 3 and Model 4) range from 300 to 850.

Extremely Influential:

- *Payment History* – make regular, on-time payments.

Highly Influential:

- *Age and Type of Credit* – use a variety of types of credit.
- *Percentage of Credit Limit Used* – keep balances low, less than 30% of credit limits.

Moderately Influential:

- *Total Balances/Debt* – reduce the amount of debt you owe

Less Influential:

- *Recent Credit Behavior and Inquiries* – avoid opening several new accounts over a brief period of time.
- *Available Credit* – only open the amount of credit you need.

Step 4. Find your motivation.

Money itself is not the end goal. The purpose of money and all of our resources is to create the life you want to live. How do you envision your life in 5 years? 10 years? 20 years? What's important to you? What are your values? Money management is easier when you have specific goals.

One of the most important things you can do to take control of your finances is to evaluate your goals. Goals give you direction and motivation for the use of your time. Take some quiet time to think about what you really want in your life. Step back and reflect on your personal values. List the steps it would take to actively work on the accomplishment of these goals. Make your goals, and the steps to achieve them, as specific as possible.

Set short-term and longer-term goals. For financial goals, we often say that short-term goals are less than one year, long-term goals are 5 years or longer, and medium-term goals are in-between. You may set different time frames for other categories. For example, if your goal was to buy a new car– your short term goal might be to save a certain amount from each paycheck. Your long-term goal might be to save a certain amount for a down payment or to pay full price for the car.

Write down your goals. You're more likely to achieve your goals if they are written down, stated in positive terms. Place your written goals where you can see them often. Most of your goals should be realistic and attainable but it's okay to have some dream goals too. Re-evaluate along the way to determine if your goals have changed. You can give yourself permission to release goals if you decide it's not what you really want.

ACTIVITY: Supplies needed are paper, index cards, pencils/pens. Ask participants to spend a few minutes visualizing the future. Where do you see yourself in 5 years? What is your job? Where do you live? How is your family situation? What does your life look like in 10 years? Instruct them to make notes about the future they envision. What can you do in the next year to move closer to that vision? Allow a few minutes for participants to make notes. Guide participants in writing goal statements based on their desires for the future. Goal statements should be written in positive terms. These can be strictly financial or can be anything else. Most goals and dreams come with a price tag. For example, a dream vacation, home or car. A new job or career may require training. A fitness or health goal might require classes, equipment, or lessons. Have each participant choose one short-term goal and one long-term goal to write on index cards (one goal per card). The participant can take home the goals cards and place them somewhere they can be seen often.

Identify money wasters. We all have little things we do during the week that take resources away from working toward our goals. These can be things like morning coffee stops, impulse buying, shopping for entertainment, etc. Often, we don't even realize how much money we waste. A good way to discover spending leaks is to keep a log or journal. Keep a detailed spending record for an entire month. Try to write down everything you purchase and the amount you spent. At the end of the month, review your spending log/journal. Think of ways to reduce or eliminate unnecessary spending so you will have more money to use towards your goals. (MP306 Expense Record Book is an optional handout that participants can use to track expenses.)

Step 5. Manage debt wisely.

When used properly, debt can be used to acquire appreciating assets and can help build your credit score. However, debt can easily become a trap.

One way to check if your non-mortgage debt is too high is to calculate a debt to disposable income ratio. Add the total of all monthly debt payments (excluding mortgage); then, divide by our net disposable income. Less than 10 percent is best. Higher than 16% and you may be getting in over your head. Aim for a ratio of 15% or lower.

Here are some other ways to tell if you are managing debt wisely:

- You're able to make more than the minimum monthly payment on credit cards or you pay balances in full every month.
- You are easily able to make ends meet and pay all of your monthly bills on time.
- You maintain an emergency savings fund that is enough to cover at least 2-6 months of expenses.

Worried that you have too much debt? Make a plan for repayment. There are many options available. One method is to pay off the card with the lowest balance first, then take the money you were paying monthly toward that card and use it to pay off the card with the next lowest balance. Another method is to use all of your extra resources to pay off the card with the highest interest rate. Pay it off as soon as possible and use the money that would have gone toward that payment to start paying more on the credit card with the next highest balance. Learn more about these and other repayment options at https://powerpay.org. Use the tools and calculators on Power Pay to determine your best repayment plan.

Summary

You can make credit work for you. Monitor your credit report by checking your free annual report every 4 months at www.annualcreditreport.com. Check your credit score as needed such as when you are shopping for a loan. Understand the components that impact your credit score and use them to build your score. Determine your personal goals. Use money and other resources to meet your goals. Keep a close eye on debt and have a good management plan.

References:

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