FAMILY FINANCIAL EDUCATION FOUNDATION

DOLLARS & SENSE

EDITION 12, VOLUME 2

Credit: The good, the bad and the nonexistent

Credit, What is it?

You might, at some point in your life, have faced the need for financial assistance or access to larger-than-usual sums of money. If a project you are working on ends up requiring additional funding, or you decide to make a large purchase such as a new home, or you become entangled in unexpected expenses, your disposable income may simply not be enough to cover the costs.

When your savings doesn't suffice, or you have no cash to your name, going for a loan ends up being your only viable option. But who will lend you money and how much will it cost you? Enter the world of credit! While venturing into credit is a common occurrence, it is often a confusing and somewhat intimidating realm that many people do not understand.

Just as you would do with your personal possessions before lending them out, a lending company wants to be confident of your capability to return it, before they agree to give you money. To do this, they rely on methods to determine the likelihood that you'll repay your debts. After all, the bank or company in question wouldn't want to generate liabilities.

To help them determine how risky of an investment you are, they rely on a calculation called a credit score. But what is a credit score exactly?

Credit Score: A Number To Rule Them All

Chances are you have heard the term "credit score, " but apart from having a "good" or a "bad" score, often people don't understand, nor are they provided an explanation of how a credit score is generated.

At it's most basic level, your credit score indicates how creditworthy you are. Your credit score is a three digits number assigned to you that has been generated by a mathematical algorithm using information from a credit report.

The information on your credit report is collected from many sources, but while there may be hundreds of regional and affiliate consumer reporting agencies that collect and store your information, these independently owned facilities feed that information to one, two or all three of the national credit bureaus.

The three national credit bureaus are Experian, TransUnion, and Equifax.

It is through these bureaus that lenders will pull your credit score. These three agencies are competitors that are independently run with no affiliation with the US government. The Consumer Data Industry Association is an international trade association that establishes, maintains, and enforces strict reporting standards for all consumer data companies including Experian, TransUnion, and Equifax.

The range of a "good" and "bad" credit score depends on what credit scoring model is used. A credit scoring model is a set of guidelines that create a mathematical algorithm.

The most common credit scoring model is the Fair Isaac Corporation also known as FICO, and it is used in 90% of lending decisions. However, there are many different credit scoring models, including industry-specific models (for example strictly for automobile purchases or credit cards). Not only

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are there a vast array of different credit scoring models, but there are also different versions of particular models (some examples include FICO 8 which penalized isolated late payments less severely or FICO 9 which treats medical debts less severely). This fact alone means that in reality, you have many different credit scores, not just one.

A FICO credit score ranges from 300-850. Although all three national credit bureaus use the FICO scoring algorithm, they record slightly different data, and that is why your score is different between each credit bureau.

In a nutshell, your credit score is created by the gathering of your financial information and running it through a particular set of guidelines (credit scoring model). Your credit score then helps determine your creditworthiness and defines the details of your loan. Things such as the amount you can borrow, interest rates, and loan terms are all determined by your credit score.

This system helps create a snapshot of your current financial situation and paints a picture of how responsible you have been in the past. If like many people you have made financial mistakes in the past, don't lose heart. Thanks to the Fair Credit Reporting Act (FCRA) signed into law in 1970; your negative debts have a limited amount of time that they can be recorded on your credit report (7 years for most debts and ten years for bankruptcy).

Because your credit score is constantly shifting and aligning itself to your current information, with a little patience and better decision making, you can improve your credit rating over time.

Get more education about your credit score

The three major credit bureaus are: Experian: **www.experian.com**, TransUnion: **www.transunion.com**, and Equfax: **www.equifax.com**. They collect and compile your credit information and create your credit score.

In 2006 the three major consumer credit scoring companies above created an alternative to the FICO score - the Vantage Score. You can find more information on their website : **www.vantagescore.com**. The website **www.creditkarma.com** inclues the Vantage Score in their report.

Learn more about your credit score and your rights to an annual free credit report from all three agencies on the Federal Trade Commission website: **www.consumer.ftc.gov/articles/0155-free-credit-reports**

Federal law requires each of the three nationwide consumer credit reporting companies—Equifax, Experian and TransUnion—to give you a free credit report every 12 months if you ask for it. Go to: **www.annualcreditreport.com**

You can check your credit score and read articles on how to work with and improve your credit at **www.credit.com**. Be aware that their credit reporting services are not free. You can also get more information on your credit scores at MyFICO: **www.myfico.com** Be aware that they are also not a free service.

TIP: Be cautious of websites that claim to offer free credit reports. A number of these sites will only give you a free report if you buy other products or services. Other sites give you a free report and then bill you for services you have to cancel. To get the free credit report authorized by law, go to www.AnnualCreditReport.com or call (877) 322-8228.

So what determines whether your credit is good or bad? What exactly is it that affects your credit?

Five Crucial Credit Elements

It is all but impossible to calculate your official FICO score yourself because the formula behind it is carefully guarded. Throughout the years, though, FICO agreed to release details regarding the composition of its formula.

Each set of data has a different weight and cover a percentage of the total credit score. The weight that each of these metrics holds depends on the model being used. As FICO is the most widely used, we will discuss their parameters:

Payment History:

Accounting for about 35% of your total score, your payment history is the most valuable information to the lender. The detailed information regarding your past debts and how well you managed to repay them are a vital part of your score. The highest credit scores will show all payments made on time.

If you have missed payments, you will see them in increments of 30 days (30, 60, 90, etc.). Often, once your late payments have reached 180 days, you will see your debt say "charge off" which means the account is closed to future use, but you still owe the debt. Mostly your lender now considers this "bad debt".

Debt Amount:

The amount of debt you hold accounts for up to 30% of your credit score and has a significant impact. Obviously, a lender might be more reluctant to accept your application if they discover that you have a lot of outstanding debt. Your debt burden is a bit more complicated than a single amount of how much money you owe. It includes how many active accounts you currently have open, your credit card utilization percent (the lower the better), and the total amount of money you owe on all accounts.

A lot of people mistakenly think that their debt-to-income ratio (DTI) will affect their credit score, but it won't. However it is a large factor to lenders, and it will affect your chances of getting a loan or line of credit. Lenders set their individual DTI standards, so what is good for one may be too high for another.

Credit History Length:

Although the length of your credit history is different than the aforementioned payment history; it can be "cross-pollinated" which means one will affect the other (after all, lenders obviously want to see a significant increment of good credit history, not bad history).

Usually, the average age of your account will be the median age of all of your open accounts (from longest held account to shortest held account). Depending on what credit scoring model is used, however, closed accounts may or may not be considered.

The longer your (good) credit history length is, the more it will boost your total score. Credit history makes up about 15% of your credit score

Total Accounts (and types of accounts):

This is the measurement of how successful you have been at handling multiple accounts and accounts of different types. Varied sources of credit behave differently and require distinct approaches.

Two of the most prevalent types of accounts are revolving accounts (credit cards) and installment accounts (mortgage, auto loans, etc.). Having several diversified accounts in good standing will improve your score. Having too little diversity in your accounts, or too few accounts may lead creditors to consider you a high risk. Additionally, closing an account won't magically make it go away. Even though it doesn't technically exist anymore, the history of that account will still be taken into consideration when calculating your score. Your total accounts and type of accounts will make up about 10% of your credit score.

Credit Inquiries:

Shopping around for the most advantageous source of credit is a smart idea, but there is a limit. A "hard inquiry" is when a lender pulls your credit to determine if you qualify for a loan.

It is important to restrict the amount of these inquiries that appear on your credit report because they will lower your credit score by a few points and remain on your credit report for up to two years. Shopping around too often in a short period could cause your potential creditor to determine that you are in too much financial need and an unreliable investment.

Additionally "soft inquiries" are credit inquiries that do not affect your credit score and that frequently happen without your knowledge. Soft inquiries are often why you get unsolicited invitations to apply for credit cards and loans in the mail. The amount of hard inquiries on your credit report accounts for 10% of your credit score.

Additional Credit Scoring Models

Although the FICO model is the most used, there are many more scoring models out there. Many lenders use individualized models, tailored to their needs or a particular industry. While some of these models failed to provide their users with data that was reliable enough to be considered trustworthy, others are still currently used as a viable alternative.

One of the more popular competitors to FICO is VantageScore, and it is the only credit score model created through a collaboration between the three national credit bureaus.

Because your credit score is determined by what information is gathered and what model it is run through, you could have hundreds of different credit scores. Your score can and will influence the response you receive when asking for a loan.

Average scores may prevent you from gaining access to more desirable loan terms and typically leads to higher interest rates than those with good credit. Additionally, a low score may render you completely uncreditworthy.

A credit score is created by the gathering of your financial information and running it through a particular set of guidelines (credit scoring model). Your credit score then helps determine your creditworthiness and defines the details of your loan. Things such as the amount you can borrow, interest rates, and loan terms are all determined by your credit score.

Often, predatory lending practices with exorbitantly high-interest rates prey upon people with low credit scores, and it is best to avoid such loans.

There are many sites online where you can find your credit score and get advice on how to improve your credit. At FFEF we offer a personal and complete review of your credit score and a 3-in-1 credit report with My Credit Plan.

You can also go to www.annualcreditreport.com and request your own annual free credit report from all three bureaus or to http://www.myfico.com/ to access your report. Be aware that many sites offer a free report for signing up with their services, but will charge you if you don't cancel the plan in the given timeframe.

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If you are on a limited budget, don't lose heart, you can also go to www.creditkarma.com and get access to your VantageScore credit score and get great advice on how to raise your credit score for free.

No matter where your credit sits right now, remember, your credit scores are dynamic, and the right set of actions can turn them around. Keeping a close eye on your financial situation by paying on time, avoiding too many loans, and using your credit cards responsibly can help raise your higher score.

I Have No Credit History! What Should I do?

While we have discussed the effects of high and low credit, what happens when you approach the world of credit for the first time? All young adults when starting out will experience a time when they have no credit. After all, if you have never had to deal with a loan before; you are unable to leave a trail of credit history.

When a bank or other lender cannot find enough data to calculate your credit score, you are simply not assigned one. Not having a credit score is often considered, by some, the same as having a score that is equal to zero.

The two thing couldn't be more different and should not be considered the same. Someone with no credit score has a "yet-to-be-determined" credit history and has not made any financial mistakes while someone with a credit score of 0 (or an extremely low score) has likely made terrible financial mistakes.

Your first step in this situation is to start building your history from scratch. Of course, having no credit will stop companies from offering you their best deals, but that doesn't translate to an inability to find a solution.

There are many credit cards with small credit limits or prepay terms that specialize in helping young adults build credit for the first time. Get one and use it for a while and you will be on your way to establishing good credit.

The Advantages and Benefits of Good Credit

Having a perfect score, one that shows your ability to handle loans responsibly and having never been insolvent before, brings several advantages. With proof of your creditworthiness, banks will be more prone to take your requests into consideration in the most favorable way.

A high credit score opens the doors to more advantageous deals and offers. Your interest rates will go down, and your credit limits will go up. While individuals with lower scores might find obtaining larger sums of money a hard task, your high score will allow you to request higher amounts.

Additionally, some things that you would never imagine are affected by your credit score are, and the higher your score, the easier it is for you to navigate through these day-to-day situations. For example, the cost of your car insurance is likely to go up and down along with your credit score. And, while everybody knows that your credit score will help or hinder buying a home, many don't realize that it will also affect your ability to rent. Landlords are likely to pull a credit report and only accept the application if you are credit worthy.

The best cell phone plans are often offered to those with good credit, and those with bad credit are forced into less desirable plans or even prepay plans. These are just a few reasons you should strive to keep an excellent credit score.

The Hidden Risks Of Good Credit

Having a good credit score is great but, just like with anything else involving money, there are some hidden risks. In fact, the higher your score is, the easier it will be for you to make a financially impulsive move and end up in trouble.

With good credit, the possibility to spend larger sums could translate to a more devastating loss if you are unable to pay it back. Caution is advised when investing in large projects. Failure to properly deal with your debt might lead to some long term repercussions. Among other things, your credit score, once perfect, might be downgraded.

In Conclusion

When approaching credit utilization for the first time, seeking guidance from someone with more experience can help ensure you make good decisions.

If your credit is in trouble and you are too deeply in debt to see your way out, credit counseling firms are a valuable tool to help aid you and get you back on the right track.

The world of credit is a complicated and often precarious place. Taking your time to explore, learn and understand it is vital to mastering it. Armed with knowledge, prudence and the right set of tools you will succeed at building good credit and improving your financial future. ■

If you know of someone who would benefit from this information, please pass this newsletter along.

For more information about our services or how we can help you with your debt management program, please contact Family Financial Education Foundation at www.ffef.org.

Family Financial Education Foundation

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