

Reading a Credit Report

Your ability to qualify for a loan depends on a credit report. A credit report is a record of an individual's personal credit history. It is probably a good indicator of the applicant's character and whether he or she will repay borrowed money as agreed.

When someone applies for a loan, the lender will order a credit report to see how well the applicant has managed credit in the past. A credit report will tell, in detail, how much the person has borrowed, from whom, and whether the bills have been paid on time.

Credit reports are compiled by credit bureaus, which regularly collect information on millions of consumers. Credit bureaus get information from a variety of sources, including stores, credit card companies, banks, mortgage companies, and medical providers. When you fill out an application for credit, the information on that application is also sent to a credit bureau.

What Are Lenders Looking For?

Lenders look for certain qualities in loan applicants. These qualities are called the "3 Cs of Credit": capacity, character, and collateral. A discussion of each follows.

Capacity – Capacity refers to the loan applicant's ability to repay the debt in question. The basic question is "Have you been working regularly in an occupation that is likely to provide enough income to support your use of credit?" More particular questions might address the following.

- ✓ Do you have a steady job?
- ✓ What is your salary?
- ✓ How reliable is your income?
- ✓ Do you have other sources of income?
- ✓ How many other loan payments do you have?
- ✓ What are your current debts?
- ✓ Do you pay alimony or child support?
- ✓ Can you afford your lifestyle?

Character – Questions will be asked to determine whether you are honest and reliable—thus likely to pay debts. Here are some examples.

- ✓ Have you used credit before?
- ✓ Do you pay your bills on time?
- ✓ Do you have a good credit report?
- ✓ Can you provide character references?
- ✓ How long have you lived at your present address?
- ✓ How long have you been at your present job?

Collateral – Collateral refers to assets that could be sold to pay off your loan in the event that you can not do so. Collateral serves as a type of insurance for the creditor. Questions related to collateral may include the following.

- ✓ Do you have a checking account?
- ✓ Do you have a savings account?
- ✓ Do you own any stocks or bonds?
- ✓ Do you have any valuable collections or jewelry?
- ✓ Do you own your own home?
- ✓ Do you own a car?
- ✓ Do you own a boat?

The Importance of a Good Credit Rating

A *good* rating on a credit report means that, in the past, bills have been paid on time. A *poor* rating indicates overdue payments or bills that have gone unpaid.

It is extremely important to build and maintain a good credit history. A good credit report can often make the difference between getting a loan or being turned down. In addition, potential employers and landlords will often check an applicant's credit report before making a final decision about offering a job or a renting out an apartment.

Credit Reports May Contain Errors

Mistakes can and do sometimes occur on credit reports. For example, a credit report may contain information about a different person with the same name as the applicant, or paid accounts may be listed incorrectly as unpaid. The law provides individuals with a means of requesting and reviewing their credit reports and having mistakes corrected. Under the Fair and Accurate Credit Transactions Act you have the right to get a free copy of your credit report from each credit bureau annually.

The official site established by the three credit reporting agencies (Equifax, Experian, and TransUnion) for free reports is www.annualcreditreport.com. The Fair Credit Reporting Act also allows you to receive a free copy of your credit report if you are turned down for credit or are the victim of identity theft.

What's My Score?

Credit reporting agencies summarize much of the information in your credit report into one credit score. The formula for computing credit scores was developed by Fair Isaac Corporation; the scores are commonly referred to as FICO scores. The scores range from 300 to 850, with the median score being 723. People with lower scores are more likely to be denied credit or charged higher interest rates. People with scores of 770 or higher will receive the best rates for loans. Scores of 640 or more will qualify applicants for fairly good rates. People with scores of 600 or less will have difficulty getting a loan. These people probably need credit counseling.

The following chart shows how lenders use FICO scores to evaluate loan applicants. For example, the chart shows that 8 percent of borrowers have FICO scores of 550 to 599, and approximately half of them either didn't pay back money they owed or were more than 90 days late in making their payments. In contrast, 27 percent of borrowers have a score of 750 to 799, and only 2 percent of them were delinquent.

FICO Scores: Measure Credit Risk

How Borrowers Rank		Delinquency Rates by FICO Scores	
Up to 499	2%	Up to 499	87%
500 to 549	5%	500 to 549	71%
550 to 599	8%	550 to 599	51%
600 to 649	12%	600 to 649	31%
650 to 699	15%	650 to 699	15%
700 to 749	18%	700 to 749	5%
750 to 799	27%	750 to 799	2%
800 +	13%	800 +	1%

Source: Fair Isaac Corporation

Who Uses Credit Scores?

Lenders aren't the only ones who use credit scores. Insurance companies use them in their evaluations of a new client's risk. A person with a low credit score may not be able to buy insurance or will be charged a higher premium. Landlords also request credit scores when evaluating new tenants. People who have difficulty paying their bills may not be able to pay their rent on time. Finally, some employers use credit scores when screening new applicants for jobs. Employers seeking to fill jobs which require the handling of cash, or jobs paying salaries over \$100,000, are especially likely to request a credit score for the applicant.

What Information Is Used to Calculate My Score?**• Payment history (35%)**

The most important part of a credit score is your repayment history. More than a third of your score is based on whether or not you have paid your bills and whether you have paid them on time. Most people are never late in paying their bills. So, if you are ever a late payer, even a few times, it will hurt your score.

How late you are (whether it's 30, 60, or 90 days) makes a difference, too. An account that was late 90 days or never repaid will hurt your score more than one that was late 30 days.

• Amounts owed (30%)

The second most important factor is the amount of debt you currently owe. This measure is based on your current level of debt compared to your income. It also includes a measure of how much credit you are currently using out of the amount of credit that is available to you. Many lenders will not make loans to individuals who are already spending 25 percent of their gross income to repay debt. They feel that the borrower will not have enough discretionary income to make additional payments, reliably, on a new loan. For example: A person who owes money on school loans, a car loan, a mortgage, and lots of credit card payments, totaling 50 percent of his or her take-home pay, probably wouldn't be able to handle any more debt.

In addition to the actual amount of debt you currently owe, lenders will look at how you are currently using of the credit available to you. If you have two credit cards with a total credit limit of \$10,000 and a balance of \$5,000 (a ratio of 5,000/10,000 or 50%) you will be more likely to qualify for a loan than someone who has a \$1,000 credit limit with a balance of \$900 (900/1,000 or a ratio of 90%).

• Length of credit history (15%)

The length of time that you have had credit affects your credit score. Sometimes people are encouraged to keep old accounts open with no balance just to help their credit score.

• Types of credit (10%)

Lenders like to see a mix of installment loans and credit cards. However, it is much more important to pay all of your bills on time than to have variety in your credit profile.

• New credit and inquiries (10%)

Each time you apply for credit, the lender will request your credit report. These requests, sometimes called inquiries, temporarily reduce your credit score. Applications for new credit following recent late payments are viewed more negatively because they are seen as a sign that you are trying to borrow to pay current debt rather than to buy a new asset.

However, there may be times—when you are shopping for a car, perhaps—when you will apply for credit at several places during a short period of time (say, 30 days) to see where you can get the best offer for a loan. These inquiries are viewed differently; they don't affect your credit score as negatively as several independent credit applications throughout the year.

What can you do to earn a good credit score or improve your score? Pay your bills on time and limit the amount of debt you take on. These two factors account for 65 percent of your credit score!

Ways to Establish and Keep a Good Credit History and Improve Your Credit Score

There are several steps you can take to establish and maintain a good credit history.

- ✓ Always pay your bills on time.
- ✓ Never borrow more than you can comfortably pay back.
- ✓ Borrow only the amount you need.
- ✓ Know how much you owe at all times.
- ✓ Contact lenders immediately if you expect to have a payment problem.
- ✓ Develop good saving habits so that you can handle financial emergencies without borrowing.
- ✓ Report lost or stolen credit cards immediately.
- ✓ Never give your credit card number or other personal information over the phone or on the internet unless you initiated the transaction.
- ✓ Open a checking account and a savings account.
- ✓ Do not apply for too many credit cards. Even if you don't use them, the credit limits are taken into consideration when you apply for credit.

Questions

- a. Briefly explain the "3 Cs of Credit".

- b. What is a credit report?

- c. Why is it important to check your credit report.

- d. How can you obtain your credit report for free?

- e. What is the difference between a credit report and a credit score.

- f. Briefly summarize the information used to calculate your credit score.

- g. Why is payment history the largest percentage of your credit score?

- h. What are some steps you can take to improve your credit score?