Issue Briefs

University of Wisconsin-Extension

2014-4

Family Financial Education

Community-based Educators Guide to Building Credit Worthiness

Credit worthiness is becoming a central part of family economic security: a priority for many families is improving credit worthiness. A good credit record can aid in access to credit, as well as a lease for an apartment, access to affordable auto insurance and even passing an employment background check.

Some people have poor records stemming from past credit problems or negative financial shocks, such as unemployment or a health crisis. Other people have “thin” credit histories—meaning they lack a long record of credit use. Both a negative record and a thin record can make it harder for families to engage fully in the credit market. People with no credit history may not be able to pull a credit report or will not have a credit score. People with thin credit reports can pull their report but do not have a credit score.

Building credit worthiness means building a strong credit record. Credit records are simply databases of information maintained by credit bureaus. With strategic choices, and patience over time, it is possible for even people with poor prior records to improve their credit standing and ultimately their credit score.

This brief summarizes how educators and counselors can work with their clients to develop credit building strategies.

What is Credit Worthiness?

Credit is measured based on credit applications, the dollar amount of available credit, the dollar amount of credit currently owed, and records of monthly payments successfully paid. Any late payments, seriously delinquent payments (60, 90 or more days late) and judgments, garnishments and other collections procedures are negative items on credit reports, as well as foreclosures, bankruptcies and other negative public records or court actions.

These pieces of data are reported by creditors to the three major credit bureaus—Experian, TransUnion and Equifax. In many ways a credit report is like a school transcript or a driver’s record. Items accumulate over time. After any negative items, like a semester of poor grades or a car accident, it takes time to recover and present a good overall record. Patterns also matter—problems in the distant past are treated less severely than more recent problems.

CONTENTS

People can "build" or "rebuild" their credit records by strategically opening and closing accounts, including paying off debt, as well as strategically adding credit accounts in some cases. Strategies typically begin with credit education, then offer guidance for opening and successfully managing payments to establish a good credit history leading to a good credit score.

A credit score is a formula-driven number, issued by a financial services provider. A well-known brand of score is FICO, which issues a score ranging from 300 to 850, with scores above 720 considered better quality and scores below 600 of worse quality.

"Credit building" often is used to refer to the process that people with thin credit records go through to augment their credit records and establish a credit score. People need a minimum of one account that has been open for at least six months to establish any score. Credit building often entails opening new accounts. "Credit repair" refers more to people who have a credit score, but that score is lower than they would like to have. For these people key strategies tend to focus on paying off debt, and sometimes closing accounts.

Some people may need to use techniques of both credit repair and credit building, especially if they have a short, but poor credit history.

Step 1: Checking Reports

By law, anyone can obtain a free credit report from each bureau one time each year. A first step is to check the report to make sure it is accurate and understand any issues.[1]

[1]See http://fyi.uwex.edu/creditreport/

In order to get a report online at https://www.annualcreditreport.com, clients need to use their full names, Social Security number, birthdate, current address and any address in last two years. It is also helpful to have a list of current open accounts—e.g. mortgage—including monthly payment for principal and interest and name of creditor to compare to the report for accuracy.[2] It is a good idea to get in a habit to check each report once per year---the UW Extension-Cooperative Extension 2/2, 6/6, 10/10 campaign is one easy way to remember.

When a report is obtained, the next step is to look for accounts that are installment loans, like auto loans, student loans, or mortgages, as well as revolving loans, such as credit cards or lines of credit. Then identify any active, open accounts (that is, with a balance), and look for any evidence of missing payments. Then look for account balances and account limits. Finally look for older, retired loans paid in full. These are positive credit records, but contribute less to credit scores. This is the basic information needed to begin making a credit rebuilding plan.

Step 2: Fixing Errors

In some cases credit building or repair cannot begin until any errors in the report are corrected, including dealing with mistaken identities and mis-reported account histories. Any disputes about items in credit reports must be taken up with each credit bureau (Equifax, Experian and TransUnion). Each bureau has its own process listed on their website. The process is often referred to as "how to open a dispute".[3] It is important that any consumer pursuing a dispute keep track of what they sent and when, printing any web-based submissions and keeping good notes.

Once the credit bureau receives a dispute, it will conduct an investigation and respond within 30 days (in some cases this is extended to 45 days). The credit bureau must provide a written response to their review and provide another free report if there are any changes to the disputed records. While each bureau is required to notify the other credit bureaus

[2]Note that anytime someone is denied a loan, the lender has to provide a copy of the report of the credit score used for the decision.

[3]Equifax – https://www.ai.equifax.com/CreditInvestigation/; Experian – http://www.experian.com/disputes/main.html; TransUnion – http://www.transunion.com/personal-credit/credit-disputes/credit-disputes.page

about any corrections, it is important to continue to monitor all bureau reports over the next year to be sure changes are made.

In some cases people should contact a creditor directly about an error—especially if the person is a current customer of the creditor and there are mistakes related to balances, account dates or payments that have been mis-reported.

One common confusion is related to lost credit cards. Typically a lender will close the lost card account and then open a new account, but with the credit history of the lost account. This may actually make the report seem like there are more accounts than there actually are.

Step 3: Paying Off Account Balances

It is important to emphasize to anyone interested in credit worthiness that making payments on time is the biggest contributing factors to credit scores. People with a history of neglecting due dates may benefit from setting up email or text message reminders about statement dates. For some people setting up automatic payments so that payments are automatically debited can be a good strategy, but only for people who are good at making sure their account balances are high enough to meet the required payments.

After paying bills on time, the next most important strategy is to use less of any revolving credit balance available. For example, if credit card has a limit of $5,000, and a borrower has a balance of $4,000, that borrower has only has $1,000 in credit left. This is not favorable in calculating a credit score. Having a lower revolving credit usage rate is better for credit ratings. Ideally people should aim for a utilization ratio below 30 percent, and ideally below 10 percent. Note that paying off installment loans (a mortgage, auto or student loan) will also help credit scores, but not as much as paying down revolving accounts.

One challenge that confuses many consumers is that even though they pay off their revolving credit every month, the balance on their credit report may be high. This is because this is the amount posted in the payment period, and any month the borrower could carry that balance to the next month. For anyone who usually pays of their balance every month, one strategy to lower the utilization ratio is to make multiple payments throughout the month so that at the date the account statement closes, the balance is relatively small. There is no reason to defer paying off the balance until the statement date (or even the later due date) if the card is mainly being used for convenience and not to borrow on credit.

Another strategy that card borrowers can try is to review any open credit cards with smaller revolving balances (for example those that can be paid off in less than three months) and pay them off as soon as possible. Then focus on any larger forms of revolving debt, increasing repayments over time. For anyone who struggles to make ends meet and who cannot seem to find a way to catch up on credit due, an additional strategy is a referral to credit counseling from a nonprofit credit counseling agency (see debtadvice.org for a list). Emphasize to any credit counseling client that receiving credit counseling will not be reported in the credit record and cannot harm credit scores.

Generally it does not help to close revolving or installment credit accounts. An older account with a poor payments history will have less and less of a drag on credit scores over time. After two years negative items are not weighted as heavily; after seven years these items disappear. It is important people understand that older accounts are still used for credit scoring even if it is closed. The main reason to close an account for someone who has a large number of active credit cards (10 or more) is concern about keeping track of open accounts. Typically these will be a mix of store credit cards and general use cards; people often do not need this many accounts. But the time for cleaning up old accounts may be after credit scores are repaired. Obviously older “good standing” accounts should remain open and active on the report as long as possible. One strategy to work with people on is to identify older accounts and then set up a plan to occasionally use these old accounts with a good repayment records to keep the account active and open. One strategy is to charge a recurring bill or charitable contribution to an older account to keep the account active. Revolving credit will generally be counted positively for a credit score as long as it is being used every few months and is paid on-time. Occasionally carrying a balance from month to month, assuming utilization ratios are low, will not have much of an effect on credit scores.

A final strategy for clients who have a good ongoing relationship with a lender, but some problems in the past (2 or more years ago) is to ask the creditor to erase a late payment from the credit report. This is called a "goodwill" adjustment and only works if the consumer has a good relationship with the lender, a valid reason for a missed payment, and a single, relatively minor period of payment problems (e.g. health crisis or family changes). Some lenders will "re-age" open accounts to erase a delinquency after a series of on-time payments (typically at least a year of regular payments).

Note that opening new accounts to increase available credit without paying off current will not have the same effect as paying down balances. Opening a number of new accounts can actually lower credit scores. Applying for credit will result in a hard inquiry in the credit report and each inquiry will hurt credit scores slightly. Credit scores usually group inquiries for the same kind of credit made within 30 days (a typical credit shopping period) as just one inquiry, so there is no penalty for shopping around for credit if someone really does need a new account.

Step 4: Building New Accounts

For people with thin credit files, establishing one more credit account in the credit report can serve to make a credit score possible. To build credit, that credit account must be both open and active. A credit builder loan or a secured credit card can be used to help people seeking to establish a stronger credit history to add to their records. Credit builder loans are a form of account where people do not receive any lump sum borrowed upfront. Banks, credit unions and some nonprofits offer these small loans where payments accrue in a savings account and then the borrower receives the loan proceeds upon repayment. This is somewhat different from a secured credit card, where borrowers deposit funds in a collateral account and then use their card and pay the balance in full every month (ideally never tapping the reserve collateral). These payments, if reported to credit bureaus, will establish credit patterns and help people to establish credit scores, or improve existing scores.

One example is Wisconsin's Park City Credit Union (see http://www.parkcitycu.org/services/credit-rebuilder.html) A borrower borrows at least $500, which is placed in a savings account. As the borrower makes monthly loan payments, the savings balance is released. All repayments are reported to the credit bureaus, and the borrower builds up a savings cushion. Park City Credit Union also partners with GreenPath credit counseling to offer online support from a certified financial counselor.

Another strategy is for a person with a thin file to become an "authorized user" on another person's credit card. The primary account holder's payment history will be reported in the authorized user's credit files. If the primary cardholder has a good record, this can enhance credit scores (even if the authorized user never uses the account). Obviously, an authorized user could make charges and the primary holder will be liable, so this is not a strategy to employ without careful consideration. This strategy is often used by parents adding their dependents as authorized users. This can help build credit, assuming the parent has good credit.

One last strategy is to explore alternative forms of proving on-time payments, such as utility payments, which are typically not reported to the credit bureaus (unless there is a problem). In some cases people can provide lenders evidence of payment histories beyond the credit report, including rent and utility statements or receipts, insurance statements, medical bill receipts, school tuition or child care statements and even cancelled checks for loans. A number of new reporting companies have been established to capture this data more efficiently.[4] Often these services require people to use an online service to pay (and track) bills paid. These systems make it easier for creditors to calculate and verify payment histories. These systems do not contribute to standard credit scores, and in some cases may incur fees and charges for the consumer. These are clearly not for all consumers, but may make sense for people trying to start over or become more engaged in the mainstream financial services after a significant life event.[5]

[4]See http://www.ecredable.com/ and http://www.prbc.com/ for examples.

[5]The Center for Financial Services Innovation has a number of briefs on these topics at http://www.cfsinnovation.com/Credit_Building

Summary

A good credit history is like an asset, and one that must be maintained over time. Most people have never formally learned how to manage their credit, making for an important consumer education topic. Importantly, if people can effectively manage their credit records, it opens the door to greater financial security, as well as more opportunities to invest in their future.

There are a number of potential ways people can build or rebuild credit worthiness as measured in credit records. As educators, it can be useful to focus on people who are most in need of improving low credit scores or establishing credit at all. Target populations may include people in public programs, survivors of domestic violence, service members and veterans, the formerly incarcerated and young people with spotty employment. Financially established families with high credit scores rarely need further help. There is no need for a "perfect score". Any score above 700 or 720 is usually good enough and higher scores will not lower interest rates very much. In any case, the most important action a consumer can take to make sure their credit record supports a good credit score is to make payments on time.

Additional Resources:

UW-Extension Check Your Free Credit Report Campaign website provides a variety of useful tools and resources for educators.

The Annual Credit Report website is the only official site for accessing free credit reports.

To learn about consumer rights or file a credit discrimination complaint visit the Consumer Financial Protection Bureau website

The Federal Reserve provides a consumer's guide to credit reports on their website.

The Federal Trade Commission's website provides information on a variety of topics concerning credit and loans, as well as alerting consumers to recent scams.

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The University of Wisconsin-Extension (UWEX) Cooperative Extension's mission extends the knowledge and resources of the University of Wisconsin to people where they live and work. Issue Briefs are an ongoing series of the Family Financial Education Team. This brief was drafted by J. Michael Collins, Associate Professor in Consumer Finance and Extension State Specialist, Center for Financial Security