

How Credit Works:

Understanding It and How to Build Yours Right the First Time



How Credit Works

Understanding It and How to Build Yours Right the First Time

Learn what information goes on your credit report, how credit scores are calculated and how businesses like financial institutions, insurance companies and potential employers use your credit history to make decisions about your future.

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Section

1

Getting Started with Credit

Without credit, most people would not be able to buy a house, purchase a reliable automobile, or just obtain some services necessary in life.



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Getting Started with Credit

Credit is an essential part of financial management. Without credit, most people would not be able to buy a house, purchase a reliable automobile, or just obtain some services necessary in life.

While there are many benefits to credit, there are also potential dangers. That makes it critical to understand how credit works and how to manage it well.

This guide will help start you on the right foot. You will learn:

- What credit reports and credit scores are and how they impact you financially
- How your credit history and score are used by lenders and other businesses
- How to monitor, improve, and maintain your credit score
- How to select the right credit card for you
- How to avoid the pitfalls of reckless credit card use





Section

2

What Are Credit Reports and Why Do They Exist?

The credit reporting system helps financial institutions avoid lending money to customers who are already overextended or who have a history of not paying their debts.



How Credit Works



What Are Credit Reports and Why Do They Exist?

Perhaps you have heard that it is important to pay your bills on time. You know that there will be negative consequences if you don't pay your bills or you have a habit of paying late.

So how does anyone know if you do or do not pay your bills? The answer is found in your credit report.

A credit report tells interested parties whether or not you are paying your bills on time, the types of credit you use (credit cards or secured loans), and if you have been keeping these accounts in good standing over the years.

You may ask yourself, "How does credit work?" "Why do I need a credit report, anyway?"

Less than 100 years ago, banking was a very personal experience. If you wanted to borrow money, you would need to walk into a local credit union or bank and personally convince a loan officer to give you the loan. You would have needed to show proof of employment and, quite possibly, personal references who could vouch for your character. The decision to grant you a loan or not was very often based solely on how the loan officer perceived your trustworthiness with limited information available to them.



Back then, nearly all lending was secured, meaning you needed to put up collateral in order to take out the loan. The most common examples of collateral secured loans are home mortgage and auto loans in which the lender takes an interest in the property. If you don't pay, the lender has the right to take possession of the collateral.

Since then, the rise of credit cards as a convenient, electronic purchasing tool has made unsecured lending quite common. And although unsecured lending can be more profitable for the lender, it's also highly risky because there's no collateral for the lender to repossess if the debtor doesn't pay back the loan.

As a result, there was a growing need for more information about individuals applying for credit. The credit report system was created to give lenders a centralized source of information about potential borrowers.

1950

By the late 1950s and early 1960s, banks began collaborating to share customer credit data including account balances and payment histories. These early "credit bureaus" were small and limited to individual communities.

In 1970, Congress first passed the Fair Credit Reporting Act (FCRA) to regulate how credit-reporting companies handled consumers' personal information, but credit reporting was still primitive compared to the comprehensive reports we have today.

By 1970, however, a few large companies emerged as leaders in credit reporting. These companies would become the three credit bureaus and credit reporting system we know today: TransUnion, Experian, and Equifax.

By the early 1980s, credit bureaus began to electronically store the detailed personal information (Social Security numbers, addresses, dates of birth) as well as the loan, inquiry, and payment data that still comprise our credit reports today.

TODAY





Section

3

What Information is on Your Credit Report?

Your credit report contains detailed information that identifies you as well as recent activity on your financial accounts.



How Credit Works



What Information is on Your Credit Report?

Your credit report contains information that identifies you, such as:

- ▶ **Name**
- ▶ **Address**
- ▶ **Social Security number**
- ▶ **Birthdate**
- ▶ **Information about your borrowing activity:**
 - ▷ loan applications you have submitted
 - ▷ credit balances
 - ▷ your payment habits or “credit history”

Your report may also contain previous addresses and employment information. Despite all of this unique information, credit report mix-ups can still occur, especially if you have a common last name like Jones or Brown. That makes it important to monitor your credit reports. This article will address this in more detail later.



The bulk of your credit report contains detailed information about recent activity on your financial accounts. This includes:



Credit inquiries:

This shows how many times you have applied for credit. An inquiry counts when you're approved, and when you are not.

Collections accounts

This will include any accounts in default that are now in the hands of a collector or collection agency. This can happen even if the original debt wasn't included on your credit report, such as a medical bill that was not paid.

Public records

These include any legal proceedings taken against you for failure to meet a financial obligation. Tax liens, court judgments, and bankruptcy filings may be included.

Open loans

The data for each open loan you have is reported. This includes:

- ▷ The name of the lending financial institution,
- ▷ The original loan amount,
- ▷ The latest balance,
- ▷ The date you opened the loan,
- ▷ Your monthly payment amount, and
- ▷ Your payment history - Your payment history details how timely you made each payment.

Closed accounts

Accounts will remain on your report even after they are closed for up to seven years.

Comments

Credit bureaus give you the ability to add comments to your credit report to explain records. Creditors can also add comments.

Open revolving accounts

Revolving credit means that it is available for you to use when you need without having to complete a new application. These are also called "line of credit" accounts and credit cards make up most of the revolving accounts on consumer credit reports. The data for these accounts include:

- ▷ The financial institution,
- ▷ Your credit limit (the maximum amount you can borrow without being approved again),
- ▷ The date you opened the account,
- ▷ Your payment history, and
- ▷ The balance on the account as of your last statement date.



Section

4

What is a Credit Score?

The better your payment history and creditworthiness is, the higher your credit score will be. A lower score means lenders will consider you a higher risk customer.



What is a Credit Score?

Your credit report will also include your **credit score**. A credit score is a three-digit number derived from the data in your credit report that potential lenders will use to determine how likely you are to repay a loan on time in relation to other borrowers.

It's important to know that the different credit bureaus may have several different versions of their score for different end uses. For example, there are specialized credit score models for mortgage lenders, credit card issuers, automobile lenders, and insurance companies. Each lender or user will decide which credit score model works best for them.

In addition, each of the credit bureaus (TransUnion, Experian, and Equifax) may report different credit scores even though most of your credit report shows the same information.

In general, however, **all credit scores fall somewhere on a range between 350 and 900**. The better your payment history and creditworthiness is, the higher your credit score will be. A lower score means lenders will consider you a higher risk customer. The score is one factor in determining whether you will be granted a loan. It is also frequently used to determine the interest rate you will be charged.





Section
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What is a Good Credit Score?

A score of 720 on the FICO scale can be considered a good credit score.



What is a Good Credit Score?

The most commonly used credit-scoring model in the U.S. is the FICO score developed by Fair Isaac Corporation. Although it depends on which score you're looking at, you can be confident that a score of 720 is good on most scales, while a score of 800 is very good. A simple ranking of credit score looks like this:



720 AND HIGHER INDICATES EXCELLENT CREDIT

Lenders will feel very comfortable that you will pay off your debt when you borrow. You will have the best chance of being approved for the best credit card offers, auto loan rates, and mortgage rates.



690-719 IS A GOOD CREDIT SCORE

Creditors may look a little closer. You will likely be able to get credit, but you may not get the best interest rate available.



630-689 IS FAIR CREDIT

You will be subject to increased scrutiny when you apply for a loan. In this range, a lender will be looking to determine if your score will be moving up or if it is on the way down to a level much riskier to them. You can expect to pay higher interest rates when your score is in this range.



SCORES UNDER 630 INDICATE BAD CREDIT

You will find it harder to get a loan or credit. It won't be impossible, but when you do get credit, your interest rate will be much higher than it would be if you had a significantly better score.





Section
6

How Do Lenders and Other Businesses Use Credit Reports?

Your credit report is looked at when applying for a loan, a job, and even renting an apartment.



How Do Lenders and Other Businesses Use Credit Reports?

Most lenders will use credit scores in two ways:

1. Some lenders will make the decision on whether or not to grant you credit based solely on your score, perhaps combined with some other data tools. Other lenders may look at factors in addition to your credit score when determining if they will grant you a loan. In nearly all cases, your credit score is a factor in your ability to obtain credit. You can expect an underwriter to look more closely at your credit report when applying for a large loan like a mortgage. You will also be under more scrutiny if your credit score is “on the fence.”
2. In addition to approving your loan, your credit will determine what interest rate you will pay for the loan. The higher your credit score is the less interest the lender will charge you for the loan. In most of these cases, the lender will set the rate strictly based on your score. Other factors that may come into play in approving your loan usually will not help improve your rate.



Real World Examples

Who cares if you pay a little higher rate as long as you get the loan? Well, you should if you care about saving money. For example a person with less-than-perfect credit that takes out a \$250,000 mortgage for 30 years at a 8-percent interest rate will pay \$179,000 more than the person with good credit that takes out the same loan and gets a 5-percent interest rate.

Sometimes, other companies will use your credit score for other decisions, too.

For example, you might be asked to submit to a credit check when renting an apartment or applying for a job that involves financial responsibility. Insurance companies often use a specific version of your credit score, often times called an insurance score, to determine how much you'll pay for car insurance.





Section
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How Do You Get a Good Credit Score?

The largest factor in determining your credit score is your payment history.



How Do You Get a Good Credit Score?

There are multiple components to achieving a good credit score:

Paying your bills on time is important

Your payment history accounts for approximately 35 percent of your credit score, more than any other factor. Making consistent on-time payments is the number one thing you can do to build a good credit score.

Not surprisingly, nothing will wreck your credit score faster than failing to pay these bills on time. The longer you take to pay them (and the more often you're late), the lower your credit score will fall.

An example: One person had good credit all her life, but once many years ago, she paid two bills a few days late. Her credit scores fell by an average of 60 points and it took two years to recover her previous good score.

Don't make the mistake of thinking you will be fine if you pay within a month of your payment due date, or pay before a late charge hits. Make it a habit to pay by the defined payment date each month. The best way to do this is to set up a payment that is automatically deducted from your checking account. This can be easily arranged through most lenders.



How does your use of debt affect your credit score?

Make no mistake; the largest factor in determining your credit score is your payment history. However, the difference between a good or fair score and an excellent score can be dependent on how you use the credit available to you, even if you pay on time!

- **Your percent of available credit used can be one of the biggest drags on a credit score. “Credit-card utilization”** (your owed balance in relation to your credit limit) affects your credit score. The higher your combined balances in relation to your combined credit limits, the more your credit score will suffer. Carrying a balance on credit cards that is a significant percent of your credit limit will lower your score. This factor is nearly as important as your payment history in determining your credit rating.
- **For the best credit score, you want to keep this “utilization ratio” as low as possible.** Work to keep your balance at or below one-third of your available credit line. Paying down your balances on unsecured debt can have a quick positive effect on your score. Increasing the amount of credit available to you can also improve your score as long as you don’t start using all that new found capacity to borrow and don’t add a bunch of new credit cards quickly.

Keep in mind that even if you pay your balance in full every month, your credit report reflects your card balance on the last day of your billing cycle. If you frequently use most of your available credit each month, your credit score will suffer even though you’re paying the balance in full every time. You can avoid this by paying off most of your balance on the day before your credit card billing statement closes. Your credit report will show a \$0 balance—or close to it.

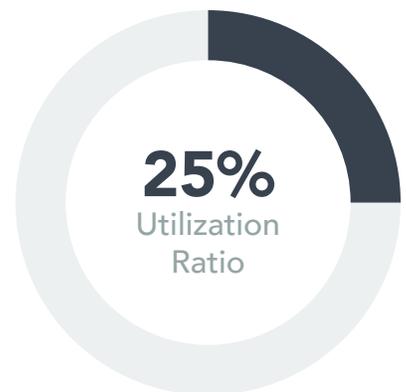
Credit-Card Utilization

Your owed balance:

\$1,250

Your credit limit:

\$5,000



For the best credit score, you want to keep this “utilization ratio” as low as possible. Work to keep your balance at or below one-third of your available credit line.





Your “credit age” - The importance of your first credit card.

The longer you have had credit accounts open, the better. Many people keep their first credit card account strictly for sentimental reasons. There are other reasons to keep a credit card open as well.

The length of time you have been receiving credit determines part of your credit score. So maintain that first credit line two ways. First, keep a perfect payment history. Second, keep the account open. As time goes on, that account open date will provide extra points to your score.



Avoid piling on debt.

Getting and maintaining good credit will enhance your score. But, do not add a bunch of new credit in a short period.

A large number of inquiries into your credit history by potential lenders will negatively affect your score and so will having several new credit accounts opened in the last two years.

Don't let this factor stop you from applying for credit when you need it, just don't go crazy and start applying for every credit card offer you receive. Be careful that you don't take on multiple store credit cards at the same time just to get a discount on your holiday shopping.

Limit your applications for new credit to no more than two every six months. Checking your own credit score is known as a "soft inquiry" and does not count toward this limit.

There's an exception for credit inquiries of the same nature that indicate you're rate shopping. If these inquiries are within a month or so of each other, they will generally only be counted as one inquiry.





Establish a healthy mix of loans.

Finally, having too much revolving credit can lower your score whereas having a good percent of your debt in installment loans can improve it.

Installment loans are loans that provide a fixed amount at account opening that you pay down with regular periodic payments. A car loan is an example. Responsibly handling installment credit can give a boost to your credit rating. You'll still want to make sure you do not take on too many new installment loans at one time, though. This can sometimes indicate that you're strapped for cash.

Too many credit applications in a short period of time can cause your score to go down because it looks like you are desperate for credit. So think twice before opening a department store card just to get the initial 20 percent discount. It may cost you more in the end if it drops your credit score.

Installment loans are loans that provide a fixed amount at account opening that you pay down with regular periodic payments. A car loan is an example.





Don't let "public records" happen to you.

Public records are one thing you definitely do not want on your credit report, because it usually means that someone has taken you to court over a debt. Many, like **tax liens** or **legal judgments** against you in favor of a lender you haven't paid, can drag your score down for years.

A **bankruptcy** filing can be the kiss of death to your credit score, at least for a number of years. Your credit score can recover from bankruptcy, but it will take between seven and ten years. Like building credit from scratch, the hardest part will be getting your first one or two credit accounts after bankruptcy. With few exceptions, this usually means starting with a secured credit card (more on this in the next section).





Section

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How Long Does It Take to Build a Good Credit Score?

A key part of credit scoring is time.



How Credit Works



How Long Does It Take to Build a Good Credit Score?

The first step—building credit by establishing a healthy mix of loans and revolving accounts—is often the trickiest, because it’s a catch-22:

You need to get credit before you have a credit history, but it is difficult get credit before you have a credit history.

Rest assured, there are several ways to establish credit for the first time, and it’s arguably easier to do when you’re young and either in college or still dependent on your parents.



Get a credit starter loan. These loans are geared to young adults that have never had a loan. They are generally for small amounts and will often carry a high interest rate since you will not have established yourself as a low risk borrower.





A starter credit card is designed for people new to credit. These cards often have:

- o Lower credit limits (\$1,000 is a common start)
- o Higher interest rates
- o Limited or no rewards

Lenders will have varying practices when it comes to issuing credit cards to someone with no prior credit.



Get a secured credit card. If you can't get approved for a starter credit card, consider a secured card. What this means is that you need to have money in a bank account equivalent to your credit line. If you want to spend \$1,000 on your credit card, you need \$1,000 in the bank to cover that. You make monthly payments like usual—it's not a debit card, where every purchase you make is deducted from your balance. That \$1,000 stays where it is in your bank account. If you fail to make payments, your payment may be deducted from your account by the lender. Don't let that happen. That may result in the lender closing your secured credit card and adversely affect your credit. Remember, the whole point of a secured card is to show you can meet the commitment of regular payments.



Take out a loan with a cosigner. A cosigner is a person with established credit who is willing to sign with you so you can get a loan. The cosigner is obligated to make payments in the event you don't. Therefore, getting someone to cosign with you can be challenging. If you go that route, make sure you fulfill your commitment. Failure to make payments may not only ruin your credit, it will likely ruin a good relationship with a friend or relative.



Ask a parent to make you an authorized user on one of their credit cards. After you become an authorized user on a parent's or somebody else's credit card, you don't even have to use the card—as long as they keep paying their bills on time, you will start to build credit. (However, it goes both ways, if they stop paying, this could actually hurt your credit! Proceed with caution.)





Finally, a key part of credit scoring is time. It typically takes three years of responsible credit use to have an average credit score in the mid to high 600s and up to seven years to develop a very good credit score of 700 or more.

It typically takes up to seven years to develop a very good credit score of 700 or more.

Remember, not all accounts build your credit history. Some accounts that DO NOT report to credit bureaus until there is a collection issue are:

- Pre-paid Debit cards
- Utility bills
- Cell phone bills
- Water bills

Your perfect payment history with these companies provides no benefit to your credit report and score but not making timely payments will hurt. Even if you have a checking account and a cell phone, you may not have a credit history.





Section
9

How Do You Fix Bad Credit?

The only way to “repair” your credit is to pay your bills, pay down debt over time, and limit applying for new credit.



How Do You Fix Bad Credit?

Let's suppose you've made some mistakes along the way and don't have great credit. What steps can you take to improve your credit score now? The same way you build good credit!

Unless you've been the victim of identity theft or otherwise have errors on your credit report, **the only way to "repair" your credit is to pay your bills, pay down debt over time, and limit applying for new credit.**

Expect it to take between one to two years of responsible credit management to make an impact on a troubled credit score (longer in the case of bankruptcy), and be wary of anybody who tries to sell you shortcuts to a better credit score.

Here are three actions you can take quickly.

1

PAY DOWN DEBT

Pay down your credit cards to leave plenty of room between your credit limit and your revolving balance.

2

CREDIT LIMIT INCREASE

If your credit is still reasonably good, apply for a credit limit increase and then make sure you keep your balance at or below 30% of the limit.

3

INSTALLMENT LOAN

Convert your revolving (credit card) balances to an installment loan.





Section
10

How Do You Monitor Your Own Credit?

The US government mandates that all consumers can receive their credit report from each of the three credit bureaus once a year without a fee.



How Do You Monitor Your Own Credit?

These days it's easy to monitor your credit score with any number of free credit monitoring apps or paid subscriptions.

You can sign up for a monthly credit monitoring service. There are both free and paid credit-monitoring services. The free services will typically give you one version of your credit score and a limited look at your credit report. Paid services are more likely to give you access to all of your credit scores and/or complete access to your credit report.

The best way to review all three of your credit reports for free is to go to annualcreditreport.com. The US government mandates that all consumers can receive their credit report from each of the three credit bureaus from this site once a year without a fee. While checking your complete reports at least once a year is the bare minimum, you should also use another free credit monitoring service to routinely monitor your score and get alerted to any problems.

Credit monitoring is also helpful if you suspect you're susceptible to someone else trying to use your credit information.





Section
11

Your First Credit Card – Doing It Right.

Managing your first credit card the right way can put you on the path to a solid credit score.



Your First Credit Card – Doing It Right.

Managing your first credit card the right way can make the difference between developing a solid credit score and putting yourself in a hole for years to come.

Select the right card for you.

If you take the time to shop all of the available credit cards on the market, you will soon discover you have taken on an overwhelming task. To keep it simple, try to limit your analysis to three main factors:

- 1. Fees** – Some credit cards require you to pay an annual fee. Over time, this has become less common and currently applies primarily to “high-end” or special reward cards. For most people, a “no-annual fee” card is a must.
- 2. Interest rate or “financing fee”** – Too often, consumers rush into credit cards for perks like rewards and special discounts only to find later that the interest rate on the credit card is exorbitant. Here is what you need to consider first.

Most credit cards will not charge you interest if you pay your entire balance off by the next due date. If you believe there will be times that you will not be able to pay off your entire balance, take the time to shop for a reasonable rate. As a first time cardholder, you won’t get the best rate, but you should be able to get a rate below 18%.

Second, know if the rate can change over time. Many credit cards carry a variable rate, meaning that as market interest rates rise, you can expect the interest rate on your outstanding balance to increase. There are still some fixed rate cards available on the market. If you plan to carry balances over time, this may be your best option.



- 3. Rewards** – Reward cards will provide you with incentives for using your card. These rewards may be in the form of points that can be redeemed for travel, merchandise, or other benefits. There are also “cash-back” cards that return a small percent of your purchase dollars to you.

Some people choose a card that offers a rewards program and then charge everything to that card to maximize their reward potential. If you know you can pay off the balance in full each month, this may be a good approach for you. However, this may not be an effective strategy.

Rewards programs and the pressure of expiration dates for redeeming reward points may encourage you to spend more than you can pay back. Knowing that you have three weeks to accumulate enough rewards to cash out at a reasonable level might encourage you to splurge.

In addition, paying for everything with debt can put you in a terrible position if something unfortunate happens. If you lose your job or don't have enough cash to pay the balance in full every month, you could be staring at a significant finance charge.

Rewards programs are nice, but they shouldn't be a deciding factor in picking your credit card. Treat your rewards credit card like a bonus, but don't plan your financial habits around it. You might get a few gift cards you can use for a nice perk every now and again, but you'll save money if you focus on less costly credit cards.

Don't bite off more than you can chew.

When you get your first credit card, it can feel like someone just gave you a key to a treasure chest containing everything you ever wanted. Remember, a credit card isn't free money. It's simply a way to obtain what you need now when you know you can pay back later. “Later” should be a defined date. Using a credit card without knowing how you will pay it back can lead to trouble down the road.

Remember, a credit card isn't free money. It's simply a way to obtain what you need now when you know you can pay back later.



Pay more than your minimum balance each month.

Credit cards enable you to buy something you need now, when you don't currently have the funds. The monthly payment on credit cards is often quite low. If you simply make the minimum payment, while continuing to use it for other purchases, paying off your loan can take forever.

Have a plan for paying off each purchase made using your credit card. For smaller purchases, you should know you can pay them in full when your next payment is due. For larger purchases, plan your budget so that you can pay off the charge in three to twelve months.

When you get your first credit card, it can feel like someone just gave you a key to a treasure chest containing everything you ever wanted.





Use technology to budget your card usage

There are mobile apps that let you control how your card can be used. You can turn your card “on or off” for use in total; by geographic area; in certain locations like restaurants, stores or online, and more.

Using this type of tool can help you control the urge to splurge. If you find yourself too often tempted by the convenience of online shopping and those ads for something you’ve been dreaming of that magically appear on every web site you visit, set your internet card access to off. You can always turn the card back on if you want to, but the simple act of having to turn the card on will get you to think twice about how necessary the purchase is. It may also give you time to think about how you will pay that debt off.

These tools are also an effective means of protecting yourself against fraudulent use of your card account by criminals. If you won’t be travelling outside of the country, set your card to “off” for international transactions. If you never use your credit card to pay for restaurant meals, disable that option.



Summary

It's the catch-22 of personal finance: You've got to have good credit to get credit, but you can't build credit unless you've got credit. There are various ways for someone just starting out to build credit and regardless of the route you take, remember the following tips about credit and how it works:

- Credit reports record your payment history on all of your installment loans and credit cards.
- Credit scores quickly summarize your creditworthiness on a scale between 300 and 900 based on the data contained in your credit report—the higher your score, the higher your chance of getting the best rates on loans and credit cards.
- Lenders use credit reports and scores to decide whether to loan money, but your credit information may also be used for apartment rentals, employment screening, and insurance underwriting.
- Maintaining a good credit score isn't difficult. Don't overextend yourself, but don't avoid credit altogether. Get a loan and a couple of credit cards and pay the bills on time.
- Check your credit now: Find the right credit monitoring service to start tracking your credit score today.

Talk to a Genisys Credit Union Member Service Representative about ways they can help you improve your score. Contact us to get your credit score moving in the right direction. Need help budgeting or making payments on time? Genisys also offers Accel Money Management to get you back on track.



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