By Greg Holmes

Credit-Score Myths and Misconceptions Alive and Well

A September poll of about 1,000 consumers conducted for San Francisco–based Visa Inc. showed that most respondents knew bill payment history and current debt levels had an impact on their credit scores. However, it also revealed that an alarming number of those surveyed had wrong ideas about other types of information being included in their scores.

A total of 64 percent believed income was a factor, 60 percent thought employment history counts, 53 percent assumed assets or savings was a consideration and 59 percent thought interest rates on current debt was taken into account. The fact of the matter is none of these items is included in calculating a credit score.

A substantial number also mistakenly believed demographics played a role. However, Minneapolis-based FICO points out on its website that it's illegal to consider age, race, religion, national origin, gender or marital status in credit scoring.

How much do you know about what goes into this critical number—and what isn't considered at all? Many myths and misconceptions still exist about credit scores due to the fact that the three repositories (Atlanta-based Equifax Inc.; Costa Mesa, California–based Experian; and Chicago-based TransUnion) won't share exactly how they arrive at their calculations.

Learning more about the data used to tabulate credit scores is vital to helping your borrowers establish and maintain a good score.

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Payment history, debt are biggest factors

A credit score does not predict whether someone is going to default on his or her mortgage. Rather, it is used to determine the likelihood of someone becoming 90 days delinquent on any consumer credit account within 24 months.

There are a total of five factors that go into the calculation of a FICO® credit score. However, of those five, just two account for 65 percent of the total. They are: payment history (35 percent) and outstanding debt (30 percent). The other three factors are length of credit history (15 percent), new account inquiries (10 percent) and types of credit used (10 percent).

Knowing this, it would appear that applicants who always (or nearly always) pay their creditors on time and who refrain from maxing out their credit cards would have little trouble building a good credit score. Yet certain activities can have damaging (or beneficial) effects on credit scores while others may have no impact at all. The difference is often in the details.

One common misconception is that a "hard inquiry" for a credit card will always negatively impact a credit score. This isn't necessarily true. A hard inquiry could potentially help improve a borrower's credit score if his score was low and he is accepted for the card.

The term "always" is what makes this likely to be false because seldom does something always impact scores in the world of credit.

Inquiry groupings within the same industry are only counted as one inquiry. For example, if a borrower is shopping multiple lenders for a mortgage and each lender pulls his credit report, it only impacts the credit score once. However, if the borrower is shopping for a car and a mortgage—two different industries—it will count as two hard inquiries against the credit score. Even if there was only one inquiry and it negatively impacted the borrower's score, the net result might be positive if the points associated with being accepted by the new card are greater than the points associated with the inquiry.

Bankruptcy removal can lower score

Here's another example: when a borrower's Chapter 13 bankruptcy reaches seven years of age and is therefore removed from her credit record, will this make her score decrease?

The answer is yes. Why? We're talking about scorecards, which are subgroups that exist within scoring models. Borrowers are placed in these subgroups based on similar characteristics in their credit files. Once the bankruptcy is deleted from her file, the borrower may graduate to a better credit subgroup.

The problem is that the borrower's score is based on how she compares with other people in her subgroup. Previously, she was compared with people with at least one bankruptcy. Her length of credit history and utilization rate may have made her look relatively good. Subsequent to removal of the bankruptcy, she graduates to a new subgroup of people with no bankruptcies, lower utilization rates and better or longer payment histories.

The analogy I like to use is the freshman quarterback who is moved up to the varsity team because he's very talented and has broken every junior varsity (JV) record. Once he is promoted to varsity, it doesn't matter what he did on the JV squad. He's now playing with quarterbacks who may be bigger, stronger and have more years of experience.

Payoff timing important

The following are some other common misconceptions about credit scores:

Paying down accounts that are charged off or in collections is always bad for the score. This is false. It's not always bad for the score. If the collection was filed in the last six months, it should help the score because zero to six months is considered current. If the account is more than two years old, paying off the collection would more than likely lower the score because it would be recent activity on a derogatory account.

A score can decrease even if there are no changes to the file. This is true. Items age with time. If an account is not used in the last 90 days, it actually starts to lower the credit score.

Reducing the revolving utilization from above 50 percent will always help the score. This is false. It doesn't always help the score. Optimal utilization is actually 33 percent.

Speaking of utilization, borrowers should avoid 0 percent credit cards. Typically, these types of accounts are issued by finance companies that provide financing for furniture or electronics stores, and customers who are issued the cards are given a relatively low credit limit. Therefore, placing a large balance on the new card (to purchase a television or a bedroom set, for example) makes the borrower's credit-utilization ratio appear high. This will be a problem for the borrower because credit utilization accounts for 30 percent of the FICO score.

Scoring tools now available

A variety of scoring tools and technology is now available to lenders to help them close more loans. These scoring tools can analyze credit files and alert lenders to opportunities they may have overlooked. In many cases, these tools suggest actions that applicants can take to reach their target scores.

Every point counts in the current lending environment, and lending standards are still very stringent. So it's worthwhile for lenders to alert applicants to problems with their credit scores—such as misreported, inaccurate or outdated information; incorrect account status or balance; and removal of derogatory information or accounts reported in error. Taking a second look at an applicant's credit score can result in a follow-up plan for the lender and client to review.

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