

Chapter 4: Credit

Build up a Stellar Credit Score Easily!

Particularly since the economic downturn of 2008-09, we often hear a lot about the importance of credit. But what technically is credit, and why is it so important anyway?

At the broad level, credit is generally understood as buying or borrowing an item now and paying for it later. We use credit to go Christmas shopping for our families or to purchase large ticket items, like cars and houses. In essence, you use credit to buy things when you do not have enough financial resources at the time to pay for it — or enough to pay for it and still have stable finances in the rest of your life.

In the financial world, there are three different kinds of credit: revolving credit, installment credit, and alternative credit (non-installment credit).

Revolving Credit

Credit cards (like VISA, MasterCard, and American Express) and department store charge cards (like JC Penny, Sears, and Macy's) are examples of revolving credit. There is a limit on how much money you can spend on a revolving credit account, and you are expected to pay off at least some of your charges every month.

Now, when you pay your bill, you can either choose to pay off your whole card balance every month, meet the “minimum payment” (often around \$50 – \$100), or pay any amount in between. Different cards have different interest rates, and any amount of money that you didn't pay off in time will be charged interest. So let's say that your card has a 15% annual interest rate, which is the national average and works out to about 1.25% per month. Then one month, you rack up about \$1,500 on things like groceries, utilities, and a new living room TV. If, at the end of the month, you pay the credit card off in full, you'll have no outstanding balance and won't be charged any interest on that original \$1,500 charge. But if you only pay off \$500 of it, there will still be \$1,000 of credit left, and you'll be charged the 1.25% monthly interest, or \$12.50. Then, your bill for the next month will have that extra \$12.50 tacked on.

With that in mind, it's important to pay down credit cards as much — and as soon — as possible. Once that \$1,000 carries over to the second month, it's hard to chip away at it. Even if you pay off all your monthly expenses and stay at \$1,000 each month, the interest alone will add up to \$150 each year. And that's not even close to the norm. Among U.S. adults with a credit card, the average credit card debt was \$5,600 in 2014; that's almost \$850 per year in interest charges!

If you're looking at credit cards, you might see something called a “credit limit,” and that's a barrier you should avoid crossing. So a credit card might have a \$3,000 limit, where you can't rack up more than \$3,000 in charges. If you go over the credit limit, the purchase may be denied; and with some credit lines, you won't be denied but often will be charged the “penalty interest rate,” which can be around 30%! Then, if you exceed the limit (whether you're denied or pay the

penalty interest rate), your regular interest rate could go up, costing you hundreds or thousands of dollars in the long run. It could also harm your credit score, which, as we'll talk about later, is a really bad thing!

Finally, some people get multiple credit cards to avoid hitting their credit limit, but this is a bad strategy in the long run. That's because the charges on the first card still stay there and keep accumulating interest. Having that outstanding credit card debt, as well as opening multiple new lines of credit, can also lower your credit score. That'll raise interest rates on future borrowing, including on any more credit cards you get, which makes things even more expensive. So remember to pay down your debt, avoid opening new lines of credit, and stay within your credit limit!

Installment Credit

Installment credit is used to pay off a single item month-by-month over a long time. So when people talk about their monthly car payment or mortgage payment, they are talking about paying off loans built around installment credit. These "installment credit" car loans and mortgages, as well as many personal loans, student loans, and even seen-on-TV products (such as that extra-super fancy blender you can get for "12 easy payments of \$29.99," for you smoothie lovers) are actually more complicated than they seem. They take an initial loan amount, set out a payment period and schedule, add on the interest on the life of the loan, and break it into monthly payments.

Now here's the thing about installment credit. Even though it seems manageable with monthly payments, it ends up costing more in the long run. We cover it a bit in the [homeownership chapter](#), but for now check out this example:

Mike bought a home that cost \$200,000 and he purchased it using a 30-year fixed-rate mortgage at 4% interest with a \$20,000 down payment, leaving him with a \$180,000 loan. The way the bank calculated the loan was a bit complex, but in the end he had an \$859 monthly payment. Not too bad for a \$200,000 house and certainly cheaper than renting. Here's the thing, though: If you multiply that \$859 monthly payment for every month over 30 years, it ends up being \$309,240 — all to pay off a \$180,000 loan. That means Mike will pay almost \$130,000 in interest! Just paying the full amount would have saved him lots of money in the end.

There's a reason that people do installment loans, though. Mike, for example, didn't have \$200,000 up-front, so no way he could have bought that house without a mortgage. But he knew that homeownership in the end was the right move because it would build up his asset base and would keep his expenses down as rents rose. Even people with \$300,000 in the bank who want to buy a \$200,000 home might still want to go the mortgage route, because they find it important to keep a buffer in savings. That's a very legitimate reason for them to take out a mortgage and the right choice for them.

You've probably heard financial advice that suggests avoiding accumulated debt wherever possible. This is often spot-on, especially when it comes to everyday expenses, such as groceries, eating out, clothing, or even that fancy-pants blender. One area where debt is generally

considered appropriate, though, is when it comes to asset building (things that maintain or increase value over time), such as through homeownership, college education, and starting a small business. Acquiring those assets usually requires installment credit. Now, taking on such large loans should be done carefully - but if you're smart about it, they can be the way to go, as smart borrowing provides the opportunity to build up your assets, have financial flexibility in the rest of your life, and improve your credit score in the long-run.

Alternative Credit

Phone, cable, gas, and electric bills are examples of alternative credit, or non-installment credit. Bills are paid at the end of the month after services have already been received. These bills are not typically listed on a credit report, but they do provide a record of whether or not bills have been paid on time. Also, not paying bills may mean that your service gets shut off in the future. And not having the cable service to watch the Kardashians — or the electricity to turn on the TV — is a situation you don't want to be in!

One final important note: When you sign up for any line of credit, pay close attention to the fine-print details of the financial agreement, not just the initial interest rate! These agreements are contracts between you and the creditor (i.e., whoever lends you the money), and they might include problematic clauses, such as the ones that allow creditors to easily raise interest rates. In fact, creditors often hope that people don't read those agreements (as happens with a lot of longer contracts) so they can benefit from people using credit cards and other loans in ways that aren't healthy for their financial life. So stay vigilant and always protect yourself from problematic contracts or predatory lenders!

Why Is Interest Charged on Our Credit Accounts?

To explain this point, let's ask a different question: What is the incentive for a bank or financial institution to give consumers a line of credit? Well, when lenders extend the line of credit, they treat it as a business transaction, and like all businesses, they expect a return on their investment. Because their whole business is lending money and getting more back in the future, the interest that they charge is what provides them with profit over time. So, we can think of interest as the cost of the money you have borrowed.

Charged interest also represents a certain buffer that protects the lender against the possibility of the borrower not being able to pay back (or defaulting on) the loan. That's not to say that every borrower will default. But if a bank gives out a lot of loans, there's a chance that at least some borrowers won't be able to pay the money back. The interest charged on everybody's accounts, then, provides the lender with a buffer in case a limited number of people don't pay off their whole loan.

You might be asking yourself: "OK, if interest is just about getting some profit and protecting against defaults, why do some loans have higher interest rates than others? Doesn't that mean that higher-interest loans get more profit?" Well, that's where credit scores and creditworthiness come in. When lenders believe that somebody is highly likely to pay back a loan, they will extend a line of credit at a lower interest rate. But if somebody is deemed to be a risky borrower,

banks will charge higher interest to hedge against the increased chance of default. And as we'll show below, a credit score represents the likelihood that you'll pay money back, so having a good score will lower the interest rates you need to pay and potentially save you thousands or tens of thousands of dollars in the long run.

Credit Score

You've probably heard of credit scores and how important they are. (Did we mention that yours is super, super important? Because it is!) But you also might be asking yourself: "What is this whole credit score thing, and what does it mean to me?" Well, a credit score is a statistically generated number, based on a borrower's credit history, that creditors use to judge that person's creditworthiness. They see it as representing the likelihood that an individual will pay the debt they build up, which, for the creditor, represents the likelihood that they'll get paid back on their loan. Your credit history doesn't just revolve around credit cards or bank loans, either. Other bills that can affect your credit score include rent, phone, cable, department store accounts, and student loans. So make sure you keep track of all your finances and pay everything in full, on time!

Taking credit scores and other information into account, lenders determine whether they'll loan you money in the first place, and what conditions they'll put on the loan (such as interest rates or maximum credit lines) if they give you one. In the end, those two factors can make a huge impact on your finances. For example, your credit score may be the difference between a 5% and a 4% mortgage. On the surface, this maybe doesn't seem like a big deal, but over a 30-year mortgage, that extra 1% will cost you tens of thousands of dollars more. Remember that example of Mike, who bought the \$200,000 house with a \$20,000 down payment? Well, if he got a mortgage with a 5% APR (annual percentage rate) instead of 4%, he would be paying \$966 per month instead of \$859 — a whole \$107 per month extra (or 12.5%, because of the compound interest), which would cost him \$38,495 over the life of the loan! That's one big difference worth avoiding!

While you can spell "credit score" with plenty of things (like these Scrabble tiles), you can't just create a good score. It takes hard work, time, and discipline.



Another consumer study has identified the troubling trend that insurance companies can also consider a credit score as part of an applicant's risk factor. Thus, people with lower credit scores may have to pay higher premiums on things like car insurance, if they are offered insurance at all. Even potential employers are beginning to ask for credit scores as part of the hiring process! You might be asking yourself, "Why should somebody who's hiring and paying me care about my credit history?" Well, it doesn't totally makes sense, but since they do it anyway, just one more reason to keep your score up!

There are many different credit scoring systems in use, and a person may actually have several different credit scores simultaneously. Each lender can also use their own criteria to determine to whom they lend to and to whom they don't. This is yet another reason to make sure that all of your bills are in order, because one slip-up could impact the potential for getting a line of credit with good conditions. In the section below, we talk a bit more about the breakdown of credit scores and how to make yours the best possible.

A huge problem is that your credit score isn't always accurate because at any given time and for a number of reasons, wrong information may be on your credit report. For example, the information for your credit score is gathered from three major American credit bureaus (Equifax, Experian, and TransUnion), but not all creditors report to all three bureaus. So, if a potential lender only pulls your score from one agency, it could be incomplete. On a related note, identity theft can significantly lower your credit score, so make sure you protect yourself against it (for more info on that, check out our [identity theft chapter](#)).

Getting Started Toward Good Credit

So far, we've been talking about the basics of good credit: Pay off your bills on time and don't take on loans you can't pay back. But building a good credit score also means that you have to show that you can responsibly manage loans and bills in the first place. To do that you'll have to

work your way up and do so responsibly. It can take some patience and determination, but it really pays off in the end. The following steps can help build a solid credit history:

- Consider applying for credit at a local business. When you are approved for credit with a local business, make sure that this information is reported to the three national credit-reporting agencies.
- Get a secured credit card. A secured credit card works just like a regular credit card but a deposit is made to “secure” the card. Think of the deposit as insurance. In case the debt is not repaid, the credit card company has the deposit.
- Make sure to comparison shop. Credit card companies charge different application fees, interest rates, and other costs. Make sure you fully understand the terms and conditions of the agreement.
- Be vigilant with your money and only use lines of credit when you can afford the purchase. Your credit score grows when you pay bills on time, so once you have lines of credit, you can use them to get better and better credit scores.
- Be proactive with your debts. If you or a family member becomes sick or unemployed and can't pay bills off right on time, make sure to contact all your creditors in order to work out a payment plan. Being proactive rather than racking up debt without a plan is the way to go, and can keep you much more stable.

Once you have established good credit, make sure to monitor all the activity on your credit report in order to keep it that way, which we talk about in the next section.

How to Build up a Great Credit Score: Hacking Your Way to 700+!

To start improving your credit score, you have to know where you are and that means knowing what's on your credit report. “Oh no, that sound just like another report card,” I hear you say. We are not fond of report cards either but this one is actually more important than the one you got in grade school.

Your Credit Report

A credit report is your personal credit history. It includes your personal identification (address, social security number, and date of birth), trade lines (credit cards and loans that you have now or had in the past), public records (like bankruptcies or lawsuits), and inquiries (how many agencies are looking at your credit report).

DID YOU KNOW? 70% of Americans' credit reports contain incorrect information and 25% of reports have errors that are serious enough that consumers will be denied credit!

SOLUTION: Monitor your credit report regularly and if you see anything wrong, let all your lenders and the crediting reporting agencies know right away! You can dispute the incorrect information online, by phone, or by mail. By law, the credit bureau has 30 days to investigate the disputed information. The credit bureau must then give you a written report of the investigation and a copy of your report if the dispute results in any change.

The Fair Credit Act allows consumers to view their credit report from the three major credit-reporting agencies free once a year. It's a good call to take advantage of this — just to keep tabs on what your future loans might be like, and also to watch out for false charges. To get those reports, check out www.annualcreditreport.com.

Three Steps to Get Your Credit Report



You will be directed to each of the three credit bureau websites to download your report. To access your report, you will be asked a personal question about your credit that only you should know the answer to. Remember to save your credit report on your computer or print it out because you cannot re-access it for free!

When you get the report, make sure to review every line of it, and if you find any errors or mistakes, you may write directly to the credit reporting agency. Explain the mistake, provide any appropriate documentation, and check back with them regularly until the issue is resolved. The documentation part is key, so make sure that you have access to all of your credit records, including having a folder with paper copies of records (such as your credit card statements or mortgage payment history).

What's in a Credit Score

Here are the major credit score components. The actual formula is a well-guarded secret, so these are good estimations based on a number of reliable sources. We have also included some suggestions, both dos and don'ts to increase your score.

Credit scores represent how much you owe, how well you repay what you owe, and how long you've been a customer. Your credit score determines the types of credit you can obtain, and how much you will be charged in interest.

The most common and most talked about is the FICO score. It ranges from 300 on the low end to 850 on the high end. Getting up to 850 is almost impossible, but being above 700 generally shows good credit worthiness. So let's check out how to get 700+.

In general, your FICO score is based on the following five components. Each one has a certain “weight,” representing how much it contributes to your final score. And even though some of them only represent 10% of the score, it’s still super important to be vigilant across-the-board, because one little component could bump you into a bracket that opens up new lines of credit or lower interest rates (or cut off credit options and raise interest rates, if you go the wrong way)!

The five factors of your FICO score

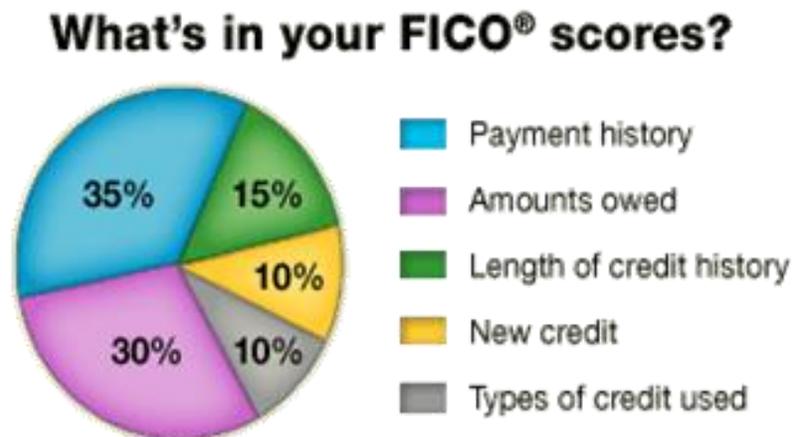
[35%: payment history](#)

[30%: amounts owed](#)

[15%: length of credit history](#)

[10%: new credit](#)

[10%: types of credit used](#)



So here’s each of those components broken down and what you need to do to make each part look extra good for your credit score.

Payment history (Score Weight: 35%)

- Pay all your bills on time
- Dispute any incorrect information
- Negotiate settlements with collection agencies

It’s amazing how important this component is. We have seen people with very good credit scores miss just one large payment, like a mortgage, and their score can drop by as much as 100 points. We can’t say it enough: pay all those bills, on time, all the time, and you’ll go a long way to building a good credit score.

Sometimes, though, your credit report will have incorrect information about your payment history. It might be that a debt that was resolved is still listed as outstanding; it might be that a paid debt was marked with the wrong amount or timeframe; and it might be that a debt was reported that you never actually owed in the first place. So when you get your credit report,

double check every line to make sure that it's correct – and if it's not, contact the credit agency to get the error resolved. It's also super important to have all your paperwork in order in case you need to resolve any errors, so keep those bills in a folder or scan them for safekeeping!

Debts that have gone to collections agencies can have an especially negative impact on your credit score. So if you have debts that have gone to collections agencies, get them resolved quickly to remove outstanding debt and minimize how long you are in debt for. Collections agencies will sometimes negotiate settlements for less than the original amount owed, so if you can't cover the entire amount, consider negotiating settlements for less than the original. This can have a couple of benefits: first, it marks those debts as resolved, and second, it lists them as smaller debts on your credit report. Both of these reduce the amount of harm done by debts sent to collections agencies.

There's one thing to note about medical debt: In 2004, FICO rolled out a new formula called [FICO Score 9](#), which generally has a positive impact for people with disabilities with medical debt. The new scoring system takes into account that medical charges, debts, and payments operate differently than non-medical finances. For example, medical charges are not usually taken on voluntarily, and many people have outstanding medical debt that they weren't properly informed about (and they might not even know of). With that in mind, FICO score 9 no longer considers resolved collection agency accounts based on medical debt, whether the account was settled for less than what was owed or if it was paid in full. It also discounts overdue medical payments relative to other, non-medical debt. This scoring system reportedly can increase a consumers' score by as much as 25 points — which can make a huge difference in financial options!

According to industry analysis, only 10% of medical debt is paid in full, often because of errors in billing, coverage, and miscommunication rather than consumers' inability to pay. This new scoring system is certainly a welcome change because many people with disabilities have substantial medical debt and charge-offs resulting from their disability — plus they just have more medical visits that might result in some error — so this will help protect credit scores in lots of situations!

Amounts owed (Score Weight: 30%)

- Keep balances below 40% of your credit limit
- A balance of less than 20% of your credit limit is best for your credit score
- Request an increase in credit limit
- Use larger down payments on installment loans (e.g., car loans or mortgages)

Your credit utilization can significantly influence your credit score. Utilization measures how much of your total credit you use during one billing cycle. Try to keep it below 40%, ideally below 20% (for example, if your credit limit is \$1000, a 40% balance would be \$400 and a 20% balance is \$200). This remains important even if you pay off your cards every month. We've seen people trying to game rewards cards by putting all their monthly expenses on a single credit card. This forces their credit utilization rate to undesirable rates, negatively affecting their credit scores, even when they pay off the card at the end of the billing cycle. Credit reporting agencies

take a snapshot of one's credit utilization — usually at the most recent credit card or other loan statement — and if one is utilizing a certain percentage of their available credit, that is the number which will be reported. So because any one billing statement could impact you negatively, it's important to stay vigilant about not using too much credit, every month!

If you find that you are going over that 20% utilization every month, you can request an increase in the credit limit on your cards. How does that impact your credit utilization? Well, when you have a higher credit limit, the exact same amount in charges will represent a smaller percentage of the limit, so you'll be better off as far as credit utilization goes. For example, a person with a \$1000 credit limit and an average credit card statement of \$400 will be using 40% of their limit. But if they request an increase in their credit line to \$2000 and still average \$400 per month, they'll only be using 20% of their limit, which could significantly improve their credit score!

In some cases, this can also apply to installment loans, like car loans or mortgages. So consider using larger down payments or paying early to cut down the outstanding amounts on those loans. Ideally, good use of credit would have us paying off our credit cards and other loans, in full and on time every month. For those of you who do, great job and keep up the good work! For those who carry a monthly balance, keep working at it, and check out our section on paying down debt.

Length of credit history (Score Weight: 15%)

- Get started early
- Keep oldest accounts open
- Do not open any new accounts you don't need

Another component of your credit score is based on the length of your open accounts. This takes into account the age of your oldest accounts, the age of your newest account, the average age of all accounts, and how long it's been since you used those accounts. A few things that stand out here are to get started early, keep older accounts open, avoid opening new accounts if you don't have to, and always have at least one account open. On the old accounts part, we've seen people wanting to simplify their financial lives close long-term accounts they rarely use, not realizing it can have a detrimental effect on their credit score. I actually still have my first credit card with a high interest rate, and use my new one almost exclusively. But I've still kept the old one open and buy a pack of gum every now and then to help my credit history. As for opening new lines of credit, don't do it unless you absolutely have to because it both hits the "newest credit line" piece we talk about next and also reduces your average credit account length.

New credit (Score Weight: 10%)

- Avoid opening multiple new accounts, including when you are just starting out
- Minimize the number of inquiries from new credit applications

Having multiple new accounts does a couple things that can hurt your score. First off, it can reduce the average length of your open accounts (which impacts the length-of-credit-history factor). It also tells the credit agency that you might suddenly have a higher credit risk, because you are trying to open more lines to cover your expenses, especially in the form of credit cards or

other revolving credit. Because of this, you should try to minimize how often you open new lines of credit. So, if you are just starting out, try to wait a couple years before opening your second or third credit account.

Applying for new credit lines will lead lenders to run inquiries into your credit score. For some things, such as car loans, this won't impact your credit score because the reporting agencies will see you as just shopping around. But for some lines of credit, such as credit cards, having multiple inquiries can reduce your score. So whenever possible, research loans and credit cards in-depth before applying to minimize the number of inquiries to your credit score. And if you can, talk to your credit card agency about just increasing your credit line instead — it'll give you the same borrowing amount, but won't hurt your credit score!

Type of credit in use (Score Weight: 10%)

- Have at least three open lines of credit
- Have a mix of loans and credit cards

Credit agencies want to see that you can responsibly use different types of credit. Because of that, having a mix of revolving credit (e.g., credit cards) and installment loans (e.g., mortgages), all with good payment history, will help your credit score. There are a couple of other little details to keep in mind. First off, there are a ton of different types of credit lines, from credit cards to retail accounts to car loans and mortgages, but you don't need one of each to have a good score, just some diversity. Second, the credit agencies will focus on this much more if there isn't a lot of other info on your credit history, which is yet another reason to manage your credit well.

See, this isn't all that complicated! And if you use credit wisely, you can build up your credit score so that you open more opportunities and save money in the future. So make sure that you follow those bullet points and build up that credit score!

A Little Internet Help

OK, so now you know the basics of credit, how to find your credit score, and steps to get a good credit score and keep it that way, and why it is so important that you monitor your credit report to make sure it is accurate. As you move forward, you need to ask yourself: What are the specific options for me when it comes to getting a new credit card or a car loan or a mortgage? There are so many credit cards and loan options out there, it's nearly impossible to research and decide!

Luckily, there are websites that can help (the Internet is pretty amazing, isn't it?). One awesome site that we've found is www.creditkarma.com. It gives you your most recent credit report and its major components (such as showing how many accounts you have open and how long you've had them), plus some recommendations to bring up your score. I actually found out that I was using just over 30% of my credit limit, which could ding my score (remember what I said earlier about a 20% balance being best for your credit score?), and promptly did a bank transfer to bring down my card balance. And if you are looking for new credit cards or loans, the website

provides a bunch of options with projected annual savings, monthly payments, and benefits and drawbacks of each card or loan option. It'll even show you what options would open up if your score increased a bit, and how much you could save in the process — how about that for some inspiration to pay your bills on time? And finally, the website is screen reader-friendly, so people with all sorts of disabilities can access it just fine.

A Note on Credit Counseling Agencies

If you choose to use a credit counseling agency to help improve your credit score, be sure to find a reputable agency. This is because in 2006, the Internal Revenue Service revoked the tax exempt status of 40% of the nation's credit counseling services for fraudulent practices, so some are better than others. Check out www.cccs.org, one of the oldest and most respected consumer credit counseling agencies. Also check out recommendations from the [Federal Reserve](http://www.federalreserve.gov) and for a more local touch, contact your local IDA program. For free credit counseling, call 800-777-7526.

The Importance of Credit

Knowing how to use credit wisely and build a high credit score can help you save tens of thousands of dollars and open lines of credit that wouldn't have been available earlier. So while you couldn't get a mortgage with bad credit (or you could only get one with a high interest rate), you can get low-rate mortgages, car loans, and more if you have good credit. This lets you save money and build up your assets, such as a home that you own (and as a double bonus, you won't have to pay rent anymore!). In all, having good credit is one of the cornerstones of a stable financial situation. So go ahead, build up your credit score wisely, avoid pitfalls that could make it lower, and set yourself up for new opportunities!



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