The FDIC Podcast – Your Credit Score

Welcome back to the FDIC Podcast, a place to talk about banking, banks and mostly…your money. I'm Brian Sullivan with the Federal Deposit Insurance Corporation and in this episode, we're going to take a look at your credit…specifically your credit *score.*

Most everyone has a credit score…although some don't and we'll talk about that …but like any score, your credit score is a number. And that number can determine whether you get a loan, how much you'll pay for that loan and it may even determine whether you get hired for a job. So, it's an important though little-understood number.

Joining us to help understand your credit score is Leonard Chanin. Leonard is Deputy to the FDIC Chairman for Consumer Protection & Innovation. He's been in the banking world for many years and has held senior-level positions both in and out of government including here at the FDIC…the Federal Reserve Board…and the Consumer Financial Protection Bureau. Leonard, welcome!

LEONARD: Thank you, Brian. It's great to be here with you.

BRIAN: Now, what is a credit score and why should we care about it so much?

LEONARD: So, let's first talk about credit reports because that's where credit scores are derived from. Banks and other lenders report information to consumer reporting agencies or credit bureaus, and they report loan information such as when you get a loan, how much the loan is for and your monthly payments. Importantly, they also report if you pay on time. So, a credit score is a number, usually three digits, like 700, that summarizes information.

That is, a score is really a statistical likelihood of the risk of payment or nonpayment. And credit scores are used to make loan decisions.

In addition, credit reports and credit scores can be used for other decisions. For example, a landlord may use a report or a score to decide whether to rent an apartment or whether to require a deposit. The same could be true for cell phone companies who may require a deposit depending on your credit report or credit score. And reports and scores can also be used for other purposes, like auto insurance, unless state or other laws restrict their use.

BRIAN: So, you mentioned 700. So that's just one number and just to be clear, the higher the score, the better, right? People with high credit scores get loans or pay less for those loans.

LEONARD: That's correct, Brian and most lenders use credit scores to review whether you'll get a loan, such as a car loan, a credit card or mortgage loan. In addition, many lenders use scores to determine the price you pay for a loan. So, scores are used to determine an interest rate, but that's within certain ranges for loans such as mortgages or car loans.

Other factors also determined the interest rate you pay. And generally, as you note, the higher the score means you get a lower rate and a lower rate will mean you have somewhat lower payments and pay less in interest for a loan.

BRIAN: Right, well, it sounds a little complicated. You said several factors go into that. What goes into that secret sauce?

LEONARD: Yeah, it is a little complicated and what goes into a credit score does vary over time as credit score developers look at the variables and look at performance of consumers. Fundamentally, it's what's in your credit report that's going to determine your score and things that have the most impact are first, your payment history, that is have you paid on time for the loans you have and, two, the amount of credit you owe?

So, let me talk a little bit about the amount of credit you owe, because it's a little bit complicated. So, let's take an example. Suppose you have a credit card. What a score looks at is really the amount you owe compared to the amount of credit you can use. So, for example, if you have a $2,000 credit line, it's better to have a balance of say $400 than a balance of $1,600, because that's going to have a more significant impact on your credit score.

Another thing that's important is the length of your credit history. For example, have you had credit for 10 years or only one year? And the longer your credit history, the more favorable the impact will be on your credit score. And as I mentioned, there are other things that also affect your credit score, like tax liens and other information in your credit report.

BRIAN: Well, just to complicate this conversation even more, there’s a number of scoring models that are out there that are based upon what sort of loan you’re applying for, right?

LEONARD: That's correct. So, it's important to recognize that consumers don't have just one credit score. In addition to their score varying over time, lenders use different scoring models to evaluate applications, for example, for car loans, for mortgage loans and credit cards. And while most credit scoring models use similar information, the models may evaluate that information in a different way. And another issue is their new credit scoring models being developed by so-called FinTech companies, financial technology companies, that use different variables and may score those variables in different fashions.

BRIAN: I don't know if consumers can ever figure out what goes into these things. Let me ask you, we had mentioned this before at the beginning, what about those who don't have a credit score at all? I would imagine they would appear to be virtually invisible in our financial world.

LEONARD: That's correct and there's been some research done. There are a number of people who don't have credit reports or who have what are called “thin files.” That is, which just has too little information to enable someone to score you. So, one option to create a bigger file if you will, is to get credit, but that seems a bit circular. So, one thing that many consumers do, if they can't qualify for credit because they have a thin file, is to get a secured credit card.

BRIAN: Explain what a secured credit card is.

LEONARD: Okay. So, for a traditional credit card, you apply to a lender and that lender is going to give you a card with a line of credit, say a thousand, two thousand dollars and you pay it according to the terms. With a secured card, it works fundamentally the same way. You apply for a credit card, you will get a line of credit. Usually it's smaller than a traditional credit card, say for example, $500, but if you have bad credit or no credit, the lender oftentimes will only give you that credit card, the secured card, if you make a deposit, let's say the example is $500 in a bank, in a savings account or a checking account for $500. Those funds are then really frozen and they're used if you don't make payments on that secured credit card. If you make your payments, then at a certain point in time, the bank will unfreeze those funds in the checking account or in the savings account. And in the meantime, you've built up your credit history.

BRIAN: In fact, in this scenario you just outlined is very much the origin story of our own Chairman when she came to this country for the very first time as a young woman. She established her credit by getting a secured credit card.

LEONARD: That's exactly right. That's exactly right and she was able to establish a credit by doing that, by placing funds within a bank and getting that card and starting her credit history.

BRIAN: And here she is the Chairman of the Federal Deposit Insurance Corporation.

LEONARD: Exactly.

BRIAN: Some of this sounds a bit counterintuitive. So, for those people who have a lot of credit, they appear to have better credit than those who don't have credit and don't have a history, right?

LEONARD: That's correct. In order to evaluate people, you have to have a certain amount of credit outstanding. Otherwise it's simply impossible to evaluate whether you'll be a good risk because it's looking at a number of consumers across the field.

BRIAN: Okay, so you mentioned maybe getting a secured credit card as a way of building or getting your foot on that first rung of the credit ladder. But what about those folks who have an established credit history and it’s not a good one, how do they improve their credit score?

LEONARD: Yeah, so the, the most important thing, as I mentioned earlier, to improve your credit score is to pay your bills on time. And if you have existing credit transactions, to try and ensure that you pay, whether it's the minimum payment or more than that, under the terms of the agreement because credit reporting agencies and those who develop scores look at the most recent information. So, if you've been late in making payments a few years ago, making payments on time in the more recent past is going to be more favorable and improve your credit score.

BRIAN: So, paying on time and servicing your debt seems to be a logical way to improve your credit but are there any little tricks people can do? Say, for example, cleaning up their credit profile if they haven't used credit in a while? Maybe cancel old accounts or such?

LEONARD: Well, certainly you want to keep your accounts current as we discussed. One of the things that bureaus look at, or those who develop scores, is information over time. So, you really want to have lines of credit and loans that have been outstanding for several years. If you want to cancel either credit cards or pay off loans, it's important that you not cancel the oldest ones. You want to keep credit cards that you've had for several years on the books because that's going to be important in terms of looking at and evaluating people's risk of repayment.

BRIAN: There've been a lot of complaints about the credit scoring models that are out there…people complain that it doesn't accurately reflect their credit worthiness? What say you on that?

LEONARD: Yes. So, credit scoring models, it's important to recognize, provide statistical predictions of the likelihood of a consumer paying his or her loan. So, models cannot state whether a specific consumer is going to pay on time. Because models are based on vast amounts of data, they determine the likelihood that a consumer will pay on time. And to determine this, the models look at a lot of information for a large number of consumers, such as the number and usage of credit cards and other types of credit and whether those individuals have paid on time in the past. So, it's really a reflection of a large number of individuals. It can't reflect whether one specific individual is going to pay on time.

BRIAN: What are a consumer's rights when it comes to their credit report?

LEONARD: Sure. So, federal law, particularly the Fair Credit Reporting Act, gives consumers the right to get a free copy of their credit report from each of the three main, nationwide credit bureaus on an annual basis…

BRIAN: …and they are?

LEONARD: Experian, TransUnion, and Equifax. And so, you can check your credit report and you should do so on an annual basis to make sure the information is complete and accurate. And if you find errors or something that you disagree with, you have the right to dispute those matters with the credit bureau and the credit bureau must investigate those matters and correct any errors within certain timeframes.

BRIAN: If there's one thing that you would leave people with, in terms of their credit score or their credit reports, what would that be?

LEONARD: So, the most single important factor that can influence your score is really paying your loans on time. And while there are other things that are important as well, that really is the thing that contributes most to having a good credit score.

BRIAN: And before we go, it's important for people to understand that there are bona fide, independent credit counselors that are out there who can help…at least help you understand your credit better, right?

LEONARD: That's correct, Brian. And they, sometimes credit reports are fairly technical documents so these individuals can help you understand what some of the terms mean and how to interpret your credit report

BRIAN: Right…and for a list of these credit counselors, you can always go to FDIC.gov, search 'credit counseling' or 'credit counselors" and that list will be provided. Leonard Chanin, thank you so much for joining us.

LEONARD: Thank you, Brian.