EPISODE 260

[ASK FARNOOSH]

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FT: Welcome back to So Money everyone. Ask Farnoosh time! TGIF! And today we're doing a little special show. We're dedicating the whole 30 minutes to credit and credit health. I've gotten a lot of questions over the last nine months when I've been asking all of you to write in to Ask Farnoosh and submit your questions, many questions around credit. And this year I've actually partnered with Chase Slate as a financial education partner and through that work I have connected with FICO, which as a lot of you know is the company that develops the FICO credit scores used in over 90% of lending decisions.

With FICO we have partnered up on some content, and Chase Slate actually has unveiled the Chase Slate Credit Dashboard this year, which shows card members their monthly FICO score. It's free, it comes with a graphical analysis of a 12-month trend other FICO score that builds over time and also gives you all the top positive and negative factors impacting your score. So it's been exciting to introduce that to customers and FICO's been a great partner.

So today to reply to all of you, to give you the exact answers to all of your questions I have a scientist with me on the line, he is Ethan Dornhelm. He is senior principle scientist at FICO. If there is a go-to person to answer your credit questions, I think I have him. So Ethan, welcome to the show!

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ED: Thanks Farnoosh. Thanks for having me.

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FT: Principle scientist at FICO; tell us a little bit about your job. It sounds highly forensic!

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ED: [Laughs] Yes, it's a catchy title for sure! And I've been with FICO for about 15 years now and when I started I was doing more of the day-to-day number crunching. I would say these days I'm more managing the teams that are doing the analysis. But certainly there's a good deal of staring at numbers and making sure we understand what the latest, greatest trends are in predicting credit risk and developing FICO scores.

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FT: Yeah I mean credit scores have really evolved over the last decade and I think really speaks to how the landscape has changed, how the economy has changed, how people are just using credit for different purposes. What would you say is kind of what's new with FICO and FICO scores these days? I know that we have a new FICO Score 9 out that's — well it's not maybe completely out, but we're transitioning, right? Tell us a little bit about the new FICO score.

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ED: Sure. So FICO Score 9 is our latest and greatest version of the FICO score, it's our most predictive score to date. That means it does the best job of identifying who's like to pay or not pay their bills as agreed in the future. We've got a number of enhancements with FICO Score 9, but I guess I would note most of all that it's just built on the latest and greatest credit bureau data that we have available. As you mentioned Farnoosh, trends change over time. The number of credit cards on average consumers have today is considerably higher than that 25 years ago when we were first building FICO scores. So we make sure we're constantly tuning the models to represent the trends we're seeing in the market.

So the latest FICO Score 9 includes improved treatment of collections information. We're now differentiating consumers who have medical collections from non-medical collections. We're now factoring rental trade lines into the calculation of the score, when that information is available on the credit report, and a number of other enhancements along those lines that, again, makes this our best FICO score yet.

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FT: Really speaking to the times because I mean I read so many articles about, especially millennials. They're not buying homes as quickly as maybe the past generation, more people are renting in that demographic, so it's good to know that you can still develop a credit history in these different ways.

You helped me with an article that I wrote for Chase Slate about the myths, the top myths that you see and I see across the board when it comes to people's understanding of credit. One of the myths was, for example, the higher your income the better your score. Which is false! Seems intuitive because of course if you make more money maybe you're also in a better credit situation. Not true!

Someone else though carrying a balance will improve my score; let's talk about that cause I actually got a question from Mike, a listener saying that he pays at least the minimum requirement on his credit cards every month. Is this enough? Or should he be aiming to pay off the full amount to keep a high credit score? I think that there is some confusing about "Should I carry a balance?" Somehow there was a message out there that got distorted [Laughs] I think about what kind of a balance you need to help your score. I've actually gotten this advice starting out and I fortunately didn't follow it, but I think this is something that is prevalent.

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ED: Absolutely. And this is one of my, I would say, biggest pet peeves as far as myths out there. This to me is one of the most dangerous ones, this idea that you need to carry a balance, pay less than the full amount you owe to help your FICO score. That's absolutely false! What the FICO score's gonna be determined off of is the balance that's reported by the issuer to the credit reporting agencies. And typically what that is is your statement balance. So regardless of whether you're paying the minimum amount or whether you're paying it off in full every month, the amount that's gonna be reported and factored into the FICO score is how much you owe at the end of your billing cycle. And so absolutely, if you can, pay off that bill in full. If you have the financial resources to do so, you should do so and not incur interest payments in the light, in the misguided belief that it's going to help your FICO score.

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FT: Another big variable in your FICO score calculation is your debt to credit utilization ratio, and that's like the second biggest variable after your bill payment history. Is there any benefit to maybe paying your bill through out the month? If you're gonna go buy tons of furniture and put it on your card, waiting till the end of the month when your utilization might be like over 50% at that point, is that gonna work against you perhaps? Or can you talk a little bit about that? This is a very, very detailed question; very specific question. Because it depends on when credit bureaus are checking your score, depending on what time of the month, it could be better to just pay off in increments throughout the month as opposed to waiting until the deadline?

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ED: Yeah you know I'd say we generally would focus on just the point that what you need to ensure is that you're keeping your debt at ta manageable level and you're keeping your balances as low, relative to your credit limits as you possibly can. So while we wouldn't advocate a particular strategy of payment versus another, we would just generally say you're usage of debt, use it responsibly, make sure you're paying it off on time.

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FT: Good advice. We have a question here from Patricia. She says:

P: I used to be bad at paying off my debt but was able to finally improve my credit score. How long will my past haunt me if I continue to keep up with low debt and an improved credit score? Will this be on my credit history for good?"

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FT: That's a good question. Time heels, right?

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ED: Yeah it absolutely does. While the technical answer is that the negative information around mis-payments will stay on the credit file for seven years. And in the case of some bankruptcies, up to 10 years. As you mentioned Farnoosh, a key dimension that the FICO score considers when it's evaluating a consumer's payment history it's not just that they've had mis-payments in the past, but how recently those occur. And so if as Patricia's done here, you can get your financial house in order and get caught back up on all of your payments, then as the time since that most recent mis-payment ages, you know time heels as you say, the FICO score will steadily increase.

And in fact we did some research a few years back that demonstrated this point. For example, a consumer who scored a 720 and who then went 90 days past due on their mortgage. That would cause their score to drop about 100 points to a 620. But if they got back off the canvas, so to speak, and consistently made on-time payments over the subsequent months we actually found their score would be able to fully recover back to that 720 within about three years.

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FT: Yeah, I get this question a lot, which is, "How long will it take for my score to recover?" Is there any other examples you can give us that — there's no absolute answer, but I think people would really benefit from hearing other encouraging anecdotes like that one.

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ED: Absolutely. Well part of how logn it will take for your score to recover is a function of how seriously delinquent the account goes. Obviously if you had just a 30 day missed payment, maybe you forgot about the bill or went on vacation or so forth, your score could recover in as little as one year. But if on the other hand you filed for bankruptcy then it probably won't come as much surprise, you're unlikely to get back to a score, let's say in the mid-700's or above, until that bankruptcy fully drops off your file some seven years later.

So I would just say, the key driver of recovery is how seriously delinquent you got in the first place. And the other point I would make is simply that while recovery may speak to getting back all the way to your original starting score before you went delinquent. And let's say you started in 800, it may be difficult to get back to an 800 any time soon. However, with responsible credit habits, managing your debt levels, paying all of your bills as agreed, you could easily get back into that mid to high 600, low 700 range where you can start once again qualifying for credit at reasonable terms.

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FT: And there is more than one credit score, right? We have more than one credit score. Which one matters? And at what point should we be concerned if there's a lot of difference our scores. And we're getting scores now from our banks, from FICO, from other websites. How do you know that the score that you're looking at is actually a good score to be measuring yourself against?

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ED: Excellent question. So has you say, there are a number of scores in the marketplace. Not all of them are FICO scores, however only FICO scores are used in more than 90% of the lending decisions in the U.S. So obviously knowing your FICO scores will give you a better understanding of how lenders will evaluate you when you're applying for a loan. So the CSTV actually did a research project back in 2012 where he was seeking to understand how similar or different the different scores that are out in the marketplace are.

And they actually concluded that some 25% of the time they were actually, what they call, economically meaningful differences between the FICO score and some of these other non-FICO scores that are sold to consumers. And by economically meaningful they just meant that the score was sufficiently different that it might result in a fundamentally different lending decision, whether that was a decline instead of an approval, or whether that was being approved at less favorable or more favorable terms. So we definitely emphasize the importance of making sure that the score you're looking at is a FICO score. And in short, if it doesn't say "FICO Score", it's not a FICO score.

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FT: And what score will get you the best interest rates these days? I know FICO, on MyFICO.com I'm often on there [Laughs], I am currently in the process of re-financing so I wanna know. And I know with the Fed expected to raise rates this year, it's really important to be aware of what kinds of credit scores can merit you certain interest rates. What's a good, well let's say, what's a great credit score if you're in the market for a mortgage or a car loan?

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ED: You know you're absolutely right, there's data that we present on MyFICO.com which shows how different FICO score bands maps to different interest rates. I believe we have tables for different products, products ranging from mortgages to auto-loans. In general, a great score is gonna be a score say in the high 700's and above. That's gonna put you in the top 25% of all consumers nationwide, and you're gonna be able to qualify for just about any credit you want at the most favorable terms if you're in that score range.

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FT: Good to know. Yeah, MyFICO is a great resource, highly recommend it. One of the other myths that we talked about in the article that I wrote for Chase.com Ethan was that closing my card account will erase it's history. A lot of people get satisfaction from closing their credit cards after they pay off massive debt. But this has potential to negatively impact your score, but not because it's gonna necessarily erase your history. What's going on when you close your credit card account that could potentially impact your score?

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ED: Yeah we never recommend closing a credit card solely for the purpose of raising your FICO score. And as you eluded it's because there are some impacts, some maybe unintended impacts that can occur from closing particularly credit card accounts on your file. And as we previously talked about, one of the key drivers of your FICO score is your credit card balance to limit ratio, or debt to limit ratio. And the lower that ratio, the further you are away from being maxed out on your credit cards, the better.

And what we see sometimes happens if people close credit accounts that have considerably large credit lines that they have very low or no credit balances on, by closing that card out they're taking away, in effect, that available credit. And when they do that it could drive your utilization ratio upwards, and that in turn can negatively affect your FICO score.

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FT: I read an interesting stat from FICO that says, "Those who have the best FICO scores, they have a utilization ratio of like 6%." That's really low! That's like if you have a $10,000 card limit you're spending, at any given point, maybe $600. So just to put things in perspective, that's those in the country with the top-notch credit scores.

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ED: That's correct. So I would say, first of all that is an average. So certainly there's plenty of consumers with high FICO scores who have utilization figures above that. And I would also mention that those who tend to score in those highest score ranges tend to have a good deal of available credit. So while on one credit they may have $10,000, that 6% figure is summed up across all of their credit cards. And it's not uncommon for us to see consumers with available credit in excess of $50,000 when you look at it from the standpoint of all of the credit accounts that they have available to them to use.

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FT: We've sort of mentioned here and there the important variables that impact your score. But very simply, Ethan, what are the top variables, the top influences on your score starting from most important to least important?

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ED: Absolutely. On MyFICO, as we talked about MyFICO.com, there's actually a pie chart that I think is a very helpful graphic that illustrates what we consider to be the five key categories of your credit report that factor into the score calculation. And so in order of importance, they are about 35% of your FICO score's going to come from your payment history, whether you've payed your bills on time in the past or not. Another 30% is from the "amounts owed" category, so this is gonna look at things like your total credit card balances, your card balances to limit ratio, your instalment loan balances, and so on and so forth. Another 15%, the third category is your length of credit history. So there we're looking at how long have you had credit on average? How long have you had all of your credit accounts?

Another 10% is the types of credit used. So here we're looking for, have you demonstrated responsible management of a broad variety of different credit products? So both revolving credit, such as credit cards, as well as instalment loans such as care loans or student loans alike. And lastly, the fifth category we focus on in the FICO score is "new credit". Another 10% of the score, roughly, is the new credit dimension, which is looking at how many new account openings or applications for credit are showing on your file.

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FT: And that's important as we head into the holiday season I think because, well you know it's gonna be high season for retailers, they gonna be pushing their store credit cards as you go and you spend and get gifts. So just keep in mind that every card application that you fill out there will be an inquiry attached to that. It's a hart inquiry, right? And that — multiple hard inquiries can negatively impact your score. However, you checking your score, yourself, it's a good thing. And it encourage and doesn't work against you. Although, that is a myth I find.

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ED: Absolutely. That's what we call a soft inquiry. If you're checking your own credit report that does not get posted to the credit file in a way that the FICO score would consider it as part of the score. So it absolutely won't impact your score for you to check your own credit report.

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FT: And I wanna address a question from Jane along the lines of credit inquiries, hard inquiries specifically. She's asking, you know:

J: "If I apply for a credit card in a department store, is one okay? Or you reach certain number and it starts to work against you. Is two, three inquiries when you're kind of in a scary place as fas as your credit score goes? How does that work exactly? Is there a science behind that, I guess?"

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ED: Well there's absolutely a science behind it but the answer, the most accurate answer is that the precise impact of an inquiry hitting the credit file will really vary from person to person, depending on the makeup of their credit file. So for example, inquiries, they can have a greater impact to your score if you only have a few credit accounts or if you've got a relatively short credit history. That said, we've done studies that have found that while inquiries get a lot of attention, there are often a focus of questions we get from consumers about FICO score impact. They generally do have a pretty small impact on the FICO score calculation.

As I said a little earlier, they make up part of that "new credit" component of the FICO score, which is really only about 10% of the score. And in fact I eluded to a study we did and it found that for most people, one additional inquiry will take less than five points off of their FICO scores. So it really is small potatoes as far as impact relative to something like missing payments or ramping up your debt burden.

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FT: And it drops off. Did you mention that too? That it drops off your credit report sooner than say a foreclosure. [Chuckles]

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ED: That's absolutely right. At most I think inquiries stay on your file for two years.

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FT: Well Ethan, this has been — I think this is as much credit education that we can digest in 22 minutes or so. Not to say that I'm not a complete nerd over this topic, I am. But I think that we have so much information jam-packed in these minutes and of course for all of you who wanna get more information about your credit score, I encourage you to go to MyFICO.com. If you're a Chase Slate customer, good news! You have access to the free credit dashboard that gives you a free FICO score as well as all of the analysis behind your specific score. So check that out if you are a Chase Slate customer.

Ethan, thank you so much for joining us and being so really crystal clear about credit scores. And so thank you for making us more aware of why our FICO score matters, how we can improve it.

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ED: My pleasure. Thank you so much for having me!

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